Investment Property Forum

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INVESTMENT PROPERTY FOCUS

The new Rolls Royce 'green' plant at Goodwood

In this Issue:

Sustainability • Corporate Responsibility • Responsible Investment

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From the editor

Long gone are the days when any consideration to the environment marked you out as a geek or an anti-capitalist hippie drop out; from housing to mixed-use schemes environmentally aware developers and architects are on the increase… and receiving substantial recognition. For example, the Peabody Trust's BedZED live/work development in Surrey boasts both environmental and social sustainability credentials and was short-listed for RIBA's Stirling Prize in 2003.

Whether it is where a development sources the materials, how it impacts on the locality or the size of the ecological footprint – the need for sustainability cannot be ignored. Fortunately there is also a good financial imperative, as discussed by this month's Investment Property Focus.

Neil Turner of **Schroders** highlights the growing interest in corporate governance from investors in the non-listed property vehicle sector who currently have no generally accepted standards. **Rupert Clarke** of **Hermes Real Estate** discusses the challenges of Responsible Property Investment (RPI) and the problem of defining what it actual means in practice. **Professor David Cadman** and **Julie Hirigoyen** of **Upstream** consider some of the links between property investment returns and sustainability risks and opportunities. The larger picture is presented by **Angus McIntosh** of **King Sturge** who emphasises that Social Responsible Investment (SRI) and Corporate Social Responsibility (CSR) are increasingly important concepts across the business world.

In this month's interview, **Sir David Clementi, Chairman of Prudential,** and **President of the IPF**, considers how proper governance is fundamental for investor confidence, which is central to how markets work and to the proper allocation of capital.

The IPF continues its education programme and Tim Horsey reports on the recent IPF debate between Chris Taite of Grosvenor, Andrew Burrell of Experian and Leo Drollas of the Centre for Global Energy Studies as to the sustainability of our current energy sources. Property professionals must understand both the reality and rhetoric of the energy debate as both have property return implications.

In another IPF debate, speakers considered if the market really should really expect continuing good returns from property. **Lord Matthew Oakeshott** of **OLIM**, **Gerald Blundell** of **LaSalle Investment Management** and **Nick Ritblat**, formerly of British Land, provided a thought-provoking debate..

The May 2006 IPF consensus forecasts of UK property investment found that total returns for 2006 were at 13.4%, up from the 11.2% reported the preceding month, and average total returns for 2006-10 are expected to be 8.0% pa.

There is no doubt that the level of finance available for property investment continues to increase. **Bill Maxted** of **De Montford University** outlines his latest survey into the commercial property lending market, revealing a 16% increase in outstanding debt during the year. **Patrick Harnan** of **Kingfisher Property Finance** discusses how investors can combine debt finance with the increasing availability of equity from opportunity funds in order to enhance returns and make maximum use of a limited equity base.

Also in this issue, **Paul McNamara** explains the Property Industry Alliance and in the IPF news headlines is the launch of the IPF Investment Education Programme for 2006.

The front cover of this issue is particularly relevant in tying all of these themes together, showing Rolls Royce's new plant which emphasises sensitive landscaping and the use of production technology to minimise environmental effects. The main roof is recently planted and is a "living green roof", which when viewed from outside blends into its surroundings. A new constructed lake in front of the buildings receives rainwater from the site which is then recycled. All of this is part if the new 'responsible' thinking in the Industry.

Contributions are always welcome, so please do contact us.

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Message from the Chairman

Ian Womack, Morley Fund Management, IPF Chairman

As I sit down to write this piece for our magazine the scary reality that I have the enormous privilege of leading the Investment Property Forum for a year has hit me hard. The purpose of this piece is to reflect on what we've done, to outline what we'll do and how we plan to do it. The challenge is daunting under any of these headings, but here we go. The Forum is a members' organisation with very clear objectives. This independence is a huge strength and is the platform for the achievements to date and for our future agenda.

Our vision statement makes clear that we will offer opinion on any issue that impacts on the efficiency of real property as an asset class and will do so without fear or favour. This means we will continue as a learned body and not a lobby group. The property world is becoming increasingly global, increasingly sophisticated and increasingly complicated, requiring new and developing skills as it takes its place as a leading asset class. At the same time the opportunities before us are huge and the Forum's research and education rich strategy puts us in a position to take a leading role as the future unfolds.

Much has happened over the past year for which this Forum can be proud. Clearly, we are excited at the opportunities presented by REITs. We are in a much better position than we ever could hope prior to the budget statement and while, at the time of writing, discussions continue and some detail is yet to emerge, there is no doubt that the Forum's influence in taking a leading role in the industry-wide working party positively effected the outcome. Particular thanks here to John Gellately of Merrill Lynch and Ros Rowe of PricewaterhouseCoopers who represented the Forum.

The other major initiative which is moving our industry forward is, of course, derivatives. This is an important development adding to the range of strategies available to real estate to manage exposure and cashflow. It follows on from the vision and lead of Immediate Past Chairman Paul McNamara of PruPIM, Iain Reid of Protego and with Rupert Clarke of Hermes, facilitating the trading game. Thanks and congratulations to them all and special thanks to Hermes for contributing proceeds from the trading game to the Forum.

As the work of the Forum develops in the fast changing world that I described, our work is hugely enhanced by the continuation of the research programme where £1m was committed by 24 generous supporters to guarantee a further three-year programme and we are enormously grateful to them all. We probably have the largest independent research budget in the country.

Much work occurred in recent months between the Forum and three other leading industry bodies to create the Property Industry Alliance. Collaboration between the major organisations representing our industry creates a stronger voice as is evidenced by the recent REITs campaign. Potential for this collaboration to enhance the opportunities for real estate cannot be underestimated and I am delighted that the Forum plays such an active role in promoting the alliance. Our research capabilities will continue to prove invaluable. Particular congratulations must go to Paul McNamara and our Executive Director, Amanda Keane. They worked enormously hard on this initiative and the opportunity to collaborate presentes an important platform for the Forum as we move forward.

Acknowledgement of the opportunity which the alliance presents is also cue for me to say how thrilled we are that Sir David Clementi agreed to be President of the IPF. He needs no introduction as his reputation goes before him. The value he adds to the Forum as we move forward and look ahead is immense. His appointment is doubly important as he also kindly agreed to undertake the role as chair of the Property Industry Alliance during the first phase of its development.

Change is the only constant and there is no shortage of challenges ahead for the Forum to address. Amongst them are the roll out of REITs, including the equalisation between REITs and CP185 funds, the lease code review, service charge review, planning gain supplement, reporting standards on indirect funds and the energy management for buildings directive to name but many! Enough to keep us busy and as shown, we will address as part of the Alliance or in collaboration with other organisations where appropriate. At all times we will preserve our standards of intelligence, integrity and independence.

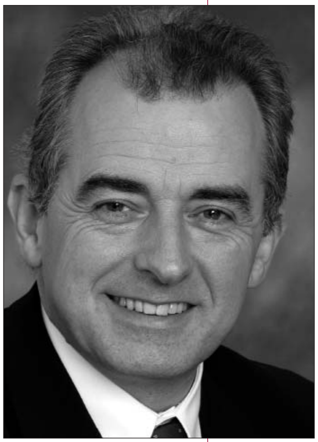
As I succeed Paul as Chairman I would like to thank him, on your behalf, for his boundless energy and enthusiasm, wise counsel and leadership during the year. He is a hard act to follow. My thanks also go to the hugely talented Management Board who probably give more time than they can spare in their busy schedules in support of the Forum and its ambitions.

As ever, Amanda Keane and her team are awesome in their quiet but strong management of the Forum and its activities. I witnessed at first hand how tremendous they are as I prepared for my year of office. They are now well settled in their new home which is another positive step forward.

Finally, may I also thank most sincerely on your behalf, Nick Ritblat who has retired from the board. Nick worked hard for the Forum and always offered sound advice and challenges – when Nick spoke the board listened. They didn't always agree but thought hard before disagreeing! The Forum's loss is the BPF's gain as he takes up the presidency.

There is so much to do but when I reflect upon the strength of the Management Board, the Executive team, the membership and the opportunities for the Forum as we move forward, I am perhaps a little less scared than I was at the start of the article but remain flattered to be here and assure you that I will do all in my power to hand the Forum on from a continuing upward path.

The Property Industry Alliance: a growing desire for action



Paul McNamara, PruPIM

Immediate Past Chairman, Paul McNamara describes the route to the four leading property bodies forming an alliance that will tackle major property issues in a more co-ordinated way while retaining their separate identities and roles.

For some time a groundswell of opinion has developed to say that the 'voice of property' continues to be diminished and diluted by the fragmented nature of representation in the property industry. There is also a strong feeling, not least from those many companies who generously support industry bodies through a multiplicity of subscriptions and fees, that there is unnecessary duplication of effort across the major representative organisations.

On the other hand, there are very many who value and respect the different aims, objectives, constituencies and pedigrees of the various representative bodies in property. For example, in the case of the IPF, members are rightly and fiercely proud of the Forum's reputation for open debate and objective research in the pursuit of a more efficient and better educated investment property market. Others feel just as passionately about the specific values and focus of the other property organisations.

Early discussions

However, it was felt that the formation of the Property Industry Alliance gives the commercial property sector a stronger voice on issues where greater coherence can make a difference. It builds on the recent REITs campaign which demonstrated the success that is achieved when organisations collaborate.

It is clear that these same discussions and debates were coming to the surface in the British Property Federation (BPF) through the summer of 2005. It is therefore not surprising that a dialogue began in autumn 2005, initially between IPF and BPF but quickly and increasingly involving the RICS and BCO, concerning how property's various representative bodies might best work together.

In exploring what might be done, the fullest set of options was considered. These ranged from consideration of possible organisational mergers to keeping things exactly as they were. Attitudes to these various options were then canvassed across a wide range of senior figures in the industry and debated at the relevant boards in the various organisations.

A number of conclusions emerged from the IPF's Management Board, namely, that something should be done to improve the level of coordination between property industry bodies but that this should not be done in any way that might lead to a new property organisation emerging or that damaged the independence of the Forum. The notion of establishing some form of informal 'council' of several representative bodies initially was the board's preferred route forward, with a strong view that no individual body should lead.

Informed by these views, discussions with other bodies have proceeded throughout 2006 and culminated in the establishment of an informal entity to be known as the Property Industry Alliance.

The Property Industry Alliance: What is proposed?

The intention is that, six times over the next 18 months, the senior board member and senior executive officer of the IPF, BPF, RICS and BCO will meet to debate issues of public policy and general property industry practice, and formulate industry-wide responses, where possible. Other bodies may become involved with the Property Industry Alliance at some later date but the current feeling is that the four organisations identified should constitute the Alliance through its trial period.

The meetings in the initial 18 months are chaired by IPF President, Sir David Clementi. Sir David took an active part in internal IPF discussions on the Property Industry Alliance and has now met with senior teams from the other participating organisations. Given his experience, both in business and through his review of representative organisations in the legal profession, Sir David is ideally suited to be the first chairman of the Property Industry Alliance.

Secretariat support for the Alliance is led by the very experienced Michael Chambers. Michael was until recently a very senior member of staff at the RICS, where he led its policy and research activities. He also has enormous experience of the property industry and the policy context within which the Alliance will likely have to operate. The BPF has generously agreed to finance Michael's involvement for the trial period of the Alliance.

The terms of reference for the Property Industry Alliance will be determined jointly at the initial meetings of the Alliance. However, they are likely to relate in some respect to:

(a) responding in a co-ordinated fashion to government proposals and initiatives;

(b) encouraging efficiency and minimising duplication of effort and activity between constituent organisations; and

(c) promoting a coherent view of the commercial property industry in a way that ensures the contribution of property to the economy of the UK and the personal wealth of its citizens.

Agreement will also be reached early on about the main topic and policy areas on which the Alliance can collaborate. Candidates for consideration might include the coordination of industry thinking on urban regeneration and sustainability, and reviewing whether there might be common ground between industry organisations with respect to planning gain supplement and the lease code.

Naturally, work on such topics needs to be delegated to expert sub-groups drawn from across these organisations and one such sub-group that is almost certain to be established is one that shares information and reviews the potential for industry collaboration on research.

The Independence of the IPF

Like all of the organisations involved, the IPF enters the Property Industry Alliance with a determination to make it work. However, it is clear that, given the very different nature and constituencies of the different industry bodies, there will be times when one or more of the various industry bodies involved will not feel able to agree a common position. In this respect, the property industry and press need to be realistic and be prepared when such circumstances arise.

In situations when universal agreement on a way forward can not be reached, the name of the Property Industry Alliance will not then be invoked. This does not stop individual organisations collaborating under their own banners but, in such cases, any action cannot be described as an Alliance initiative.

The arrival of the Alliance will raise some challenges for the IPF. More than ever before it must 'know its own mind' on the issues of the day. In doing so, it will naturally examine and evaluate those issues through its 'lens' of what impact they have on the efficiency of the property market and the understanding of property as an asset class. Anything proposed by Alliance members that does not fit with these aims, will be objected to by IPF and, as explained above, the name of the Alliance will not be invoked. The hope is that such circumstances will be rare. However, it is in this way that the independence of the IPF is maintained.

A natural step

The Property Industry Alliance represents a natural and evolutionary step for the property industry. In truth, the main industry bodies have worked long and hard together and to great effect in recent years on issues such as REITs, property derivatives and the lease code.

However, communication can always be improved and there is real benefit in hearing the voice of property more loudly and understood more fully. The existence of the Alliance reduces the danger of wasting industry resources through overlap and duplication. To this end, the IPF is determined to play its part in making the Alliance work.

The first meeting of the Property Industry Alliance took place on May 22nd and progress of that meeting will report in the next edition of **Investment Property Focus**.

Corporate governance and the property sector

There is currently much interest in non-listed real estate vehicles. They have grown by a significant degree in the last few years and provide a very important investment medium for many types of investor. There is also increasing interest in the corporate governance of these vehicles.

At its recent annual conference The European Association for Non-listed Real Estate Vehicles (INREV) launched its Corporate Governance Guidelines white paper. The white paper is the culmination of detailed surveys and consultations with its membership during 2005 and 2006. The INREV mission statement for this paper is strong and should bring some coherence to the thinking.

> INREV corporate governance white paper mission statement
>
> Currently the non-listed property vehicle sector has no generally accepted standards of corporate governance; a set of clear, uniform and agreed-upon standards will increase investor confidence in the sector.
>
> For more information please go to www.inrev.org

We also understand that The Association of Real Estate Funds (AREF) is undertaking consultation in this area in the coming months. In both of these cases, the IPF is aware of these discussions and, as appropriate, the IPF will keep members informed.

All of this activity shows that investors, for a multitude of reasons, are taking a keen interest in corporate governance as pressures mount to ensure investments measure up to the highest standards. The issues that investors are particularly focused on are:

- A significant majority of investors acknowledged that good corporate governance would involve having independent officers (non-executives) operating within the fund vehicle to represent their interests
- Concern as the lack of transparency and market information on some non-listed real estate vehicles.

Corporate governance

What about non-executive directors? It is now fairly common practice for investors to make such appointments. These non-executives are there to protect the investors' interests by monitoring the performance of a fund with respect to business plans, adjudicating on key conflict of interest issues that may arise and ensuring that the fund is complying with its own constitutional terms. This role is particularly important, of course, where investors are not closely involved in the day-to-day running of the fund.

These non-executives also need to be independent. They need to be independent because they must be able to discipline managers and ensure that they place investors' interests ahead of their own, where this is necessary.

Neil Turner, Schroder Property Investment Management

Transparency

Here, it is clear that we, as an industry, still have progress to make. Lack of transparency in this area is still a key reason investors provide for their lack of enthusiasm for investing through this conduit.

We all recognise that fee structures embedded within non-listed real estate vehicles are, by their nature, extremely diverse. This heterogeneous nature has meant that it is extremely difficult for consumers of product to compare the true cost of investing between funds and fund types and, indeed, for providers themselves to benchmark their own fee levels during product development.

So, while it is relatively easy to compile information regarding annual asset management fees across fund types, these measures are surely limited in their ability to capture the true cost of investing in non-listed funds. Such widely publicised fees tell investors nothing about the many other costs embedded within the fee structures that are prevalent within our industry.

There are various initiatives underway within the industry to improve this situation. This involves having industry-agreed definitions and terms so that managers are able to provide information in a consistent manner to facilitate the comparison of fund fees across vehicles.

Wherever the industry decides to go on this particular issue, whether it adopts total expansion ratios (TERs) for non-listed funds or arrives at a more appropriate metric for our asset class, is uncertain, but we believe that greater transparency in relation to fees and costs is essential. A stable foundation for understanding in this area would greatly enhance the industry's standing.

Responsible Property Investment – are you prepared to meet the challenge?

In this issue the IPF continues to look at the vast range of issues encompassed by Corporate Social Responsibility which investors must consider as they determine investment strategies. Here, Rupert Clarke of Hermes, considers the challenges to embrace when considering Responsible Property Investment (RPI).

'Responsible property investment, corporate social responsibility, environmental impact of climate change, going green, tree hugging... suddenly everyone is getting very worked up about all of this but, if I'm honest, I'm not really sure what's involved or indeed what I should be doing about it?'

If you identify with the above then it is probably fair to conclude that neither you nor your business are entirely ready to meet the looming challenges of responsible property investment. And given that until very recently it has been very difficult, if not impossible, to obtain a clearly articulated summary of what responsible property investment actually means in practice, you can be forgiven for this.

Since Hermes Real Estate made significant efforts to tackle RPI, and in the absence of any other definitive reference point on RPI, at the end of last year I asked the team to define what was involved (see box summary opposite). These challenges provide a transparent framework for consideration by third parties and those within the wider property market who are seeking to pursue an RPI strategy.

In establishing this framework, Hermes has discussed RPI with a range of investors, managers and specialists. As well as no consensus on a clear definition of RPI, we found uncertainty in whether the potential cost of RPI can be justified. Since this is also of significant concern to our investors we have considered this in more depth and, in our view, the answer falls into two areas.

Firstly, and most importantly, there are many areas where RPI adds value through limiting risk, increasing the appeal of a property and ultimately underpinning and improving returns. For example, complying with legislation and tracking potential legislation limits financial risk and besides, the potential for reputation damage makes compliance a non-negotiable standard. Operational efficiency can provide directly measurable financial benefits through cost savings and in certain circumstances there is the potential to generate additional revenue. Also, development and investment sensitive to community needs gains quicker and earlier support from planners, grant providers, occupiers and users.

In addition, in the medium-term and as the subject grows in importance, the combination of occupier and investor awareness of these issues will have a direct impact on rental and investment values positively for those buildings that are RPI compliant – and negatively for those that are not.

Rupert Clarke, Hermes Real Estate

Secondly, it is important for all to recognise that RPI cannot be a "no expense spared" commitment. Hermes, and investment managers in general, have a fiduciary responsibility to their investors. Those elements of RPI that are not mandatory, must be measured on their ability to add value – or at least not dilute it. While solving that financial equation can be difficult at times, a cost benefit analysis must always be borne in mind in finalising asset specific and overall RPI strategies.

So how does Hermes measure up against these challenges? While we deliver top quartile performance in a large number of the key indicators, there are certainly many areas where we can improve. However, the responsible property investment challenges now provide us with a clear framework in which our progress can be developed and measured.

As the understanding of RPI grows, so we expect this framework to evolve. To this end, Hermes actively encourages debate on RPI, both as a means of refining these challenges and in order to raise market awareness of a subject which is becoming increasingly important.

For more information on this topic please go to www.hermes.co.uk including a full 20 page document which expands on the detailed approach to the following challenges.

Responsible Property Investment – the challenges

As RPI becomes more widely discussed and understood, property owners' and managers' approach to RPI will need to develop to reflect and respond to this. They will need to broaden corporate awareness of the strategic importance of RPI and establish specific strategies and systems to ensure that the RPI challenge can be met in relation to its component parts. The challenges outlined below, and covered in more detail on the Hermes website, provide operational guidelines and a framework to enable property owners and managers to articulate their approach to RPI with confidence and to further develop their approach as the demands of RPI evolve.

Challenge 1: Compliance

Property owners and managers pursuing RPI strategies must ensure that they, and the property assets they manage, comply with all current legislation and regulatory requirements and demonstrate preparedness for forthcoming legislation. In particular, they should demonstrate a commitment to the highest standards of health, safety and welfare, the prevention of pollution and the efficient use of resources.

This sets out a basic requirement for all property assets and provides an essential starting point for an RPI strategy.

Challenge 2: Good practice

Property owners and managers pursuing RPI strategies should work towards good practice in relation to their most significant impacts. In particular they should cover the following areas:

- Environment: ensure property assets make a positive long-term contribution to the protection and enhancement of the local and global environment. Property assets should be acquired, developed, managed and disposed of with particular regard for the efficient use of natural resources and impact on local ecology.
- Communities: Develop and manage property assets with consideration for the impact on local communities and support local communities in improving their quality of life.
- Stakeholders: Develop and manage property assets through effective relationships with stakeholders.

The challenge is to take a proactive approach to specific impact areas, seeking to adopt good practice on a case by case basis where it can be demonstrated to have a neutral or positive affect on investment performance.

Challenge 3: Strategy

Property owners and managers pursuing RPI strategies should acquire, develop, manage and dispose of property assets in line with a strategy which takes into consideration the environmental and socio-economic risks and opportunities that contribute to the properties ability to deliver long-term investment performance.

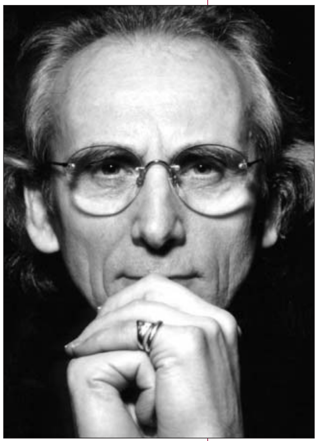
The challenge is to develop and integrate approaches to legislative compliance and good practice to inform and influence long-term investment strategy as well as adopting them in the day-to-day property process.

Challenge 4: Management systems

Property owners and managers should have appropriate systems and procedures in place to ensure that RPI can be effectively implemented. These should be supported by performance evaluation systems designed to incentivise the delivery of long-term investment value by those responsible for the property asset. Property assets should be acquired, developed, managed and disposed of by those who are able to demonstrate that they have the strategies, competency, skills and resources in place to address these RPI challenges.

The challenge is to ensure the efficient and reliable delivery of the RPI strategy, a requirement which becomes increasingly critical if multiple custodians are involved in the property process.

Sustaining value: sustainability and property investment



Professor David Cadman, Upstream

Professor David Cadman and Julie Hirigoyen of Upstream presented to IPF in April some of the latest findings which contribute to the growing debate on sustainability. The IPF hopes to continue to foster and support the interest in this area with more research being commissioned by the new IPF research programme.

Over recent years, institutional property investors have begun to consider the ways in which the growth of corporate responsibility and socially responsible investment might impact upon the performance and management of their portfolios. Large among their concerns has been a growing list of environmental issues and, perhaps most especially, those relating to climate change.

The purpose of this article is to introduce some of the potential links between property investment returns and sustainability risks and opportunities, in part by reference to a particular initiative – The Third Dimension – being undertaken in partnership by Upstream and PMA. However, before describing this initiative, it might be interesting to describe in more general terms a number of other ways in which institutional investors are addressing their corporate responsibility.

For the past eight years, Upstream has undertaken an annual benchmarking exercise in which institutional investors and property companies compare their, at first environmental, but now their sustainability, engagement and practice. This benchmark includes measures that relate to corporate strategy and to the management of both standing investments and new developments. Organisations have used the benchmark, not so much as a simple ranking device with winners and losers, but rather as a way of exploring the characteristics of good practice, to see how they compare to such a measure and also see what they have to do to improve. Some of these companies have also gone on to benchmark the sustainability impacts of individual properties in Upstream's Shopping Centre Benchmark and will also be part of Upstream's 2006 Office Benchmark. Supporting this, much work has been done to help institutional property investors establish and manage their corporate responsibility and sustainability strategies but it has always been the case that the institutional investors were a little behind the property companies in managing sustainability impacts across their portfolios.

A few relatively recent initiatives suggest that this position may be about to change, and show that institutional investors are increasingly seeking to manage social and environmental risks and relate them to financial performance.

The first of these is the corporate responsibility strategy of PruPIM, which brings together eight distinctive corporate responsibility (CR) initiatives under a common and coherent strategy. Running over three years (2005 to 2008), the strategy seeks to address the significant social and environmental impacts associated with overall investment strategies, property management, construction and procurement activities. It also recognises the need for responsibility to be embedded in the communication of the company's corporate culture and overall business conduct as well as in its commitment to community investment. The PruPIM approach is founded on the principle that a credible CR strategy must be aligned with mainstream business objectives, and that it should both create and sustain value for the business. This is achieved, in part, through a CR governance structure which includes key decision-makers throughout PruPIM's business at a senior level.

The second initiative is Hermes' responsible property investment (RPI) challenges. Launched earlier this year, this strategy proposes for the property sector four key challenges related to compliance, good practice, strategy and management systems. These challenges provide Hermes itself with an operational framework and standard against which its management teams can measure performance. In proposing the RPI challenges, Hermes decided there was no such definitive reference point in the property sector. The idea is that the challenges will provide a clear framework to third parties and the wider property market. Hermes believes the effective implementation of RPI will add value through limiting risk, increasing the appeal of property, and ultimately underpinning and improving returns. Hermes says it recognises that RPI cannot be a 'no expense spared' commitment, and believes it has a fiduciary responsibility to its investors in addressing all areas of RPI.

Perhaps these initiatives are not all that surprising. Faced with rising landfill costs, soaring energy prices, the recent increase in the Climate Change Levy, the forthcoming EU Energy Performance of Buildings Directive and the demanding sustainability requirements of planning authorities, property companies and institutional investors alike are deriving value from improving their management of sustainability matters in the design, construction and operation of their buildings.

Although the market is not yet pricing sustainability attributes accurately, it is clear that there is increasing interest in incorporating such considerations into valuations. Kingston University's Sustainable Property Appraisal Project, which seeks to evaluate the impact of sustainability upon a property's 'calculation of worth', seeks to identify where these impacts are felt and the actual impact of them on property valuations. This is work in progress and further results are awaited.

The Third Dimension

With this as a background, we can now say something about the project being carried forward by Upstream and PMA – The Third Dimension. The Third Dimension is a project established for a syndicate of institutional investors. The syndicate presently includes more than 30 funds and assets of close to £40bn – about one third of the value of all the funds in the IPD industry benchmark.

Taking risk (measured by beta) and return (expressed as total return) as the first two current dimensions of property investment analysis, this analytical tool introduces a third dimension, that of sustainability. Across 11 separate property types (broadly based on standard IPD property types), the analysis is constructed in three integrated levels:

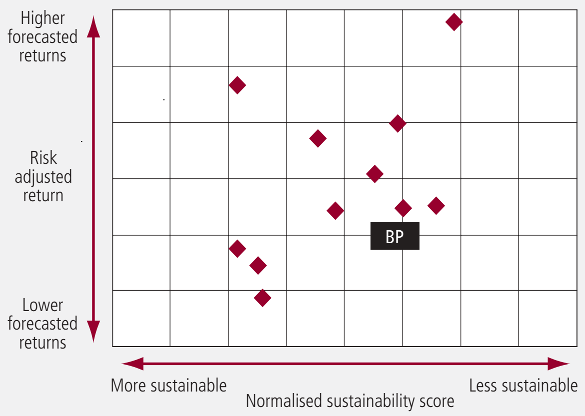
- Three elements of sustainability – the economic, the social and the environmental.
- Thirteen criteria – spread across the three elements.
- Fifty five questions – spread across the thirteen criteria.

The questions are asked in such a way that the score for each property type rates it in relation to all the other property types. An example might be to question whether one or other property type typically uses more or less than average energy in its day-to-day operation; another might be whether one or other property type generates more or less than average waste in the course of its construction.

When applied to the 11 property types, the 55 questions constitute 605 separate measures of sustainability which are then subjected to differential weighting (related to their significance in terms of sustainability) before being added together to provide a sustainability score for each of the property types.

Although the need for confidentiality prevents the publication of the actual results for each of the property types, Figure 1 shows, in general terms, the spread of results based upon comparing the sustainability scores of the 11 property types against risk-adjusted returns (expressed as total returns). The measures of return and risk are based upon PMA's latest 10-year forecasts and the measure of sustainability is based upon Upstream's sustainability scores, which also look towards a medium-term outcome (five to 15 years). By conflating the risk and return measures into a single risk-adjusted return, it is possible to show this two-dimensional presentation of the results.

Figure 1: Risk-adjusted returns versus sustainability



While the findings of this analysis are confidential to the syndicate that is supporting this analysis, by way of example we can say that the dot marked 'BP' in Figure 1 represents the score for business parks. This type of property has rather below average forecast returns (but not the poorest) and close to average risk (as measured by beta). More worryingly, it has a very poor sustainability score. For the fund manager, this analysis therefore, poses medium-term questions about the extent to which business parks will perform against other types of property given its vulnerability, for example, to regulation and fiscal penalties that may be brought about by government's wish to constrain car and other vehicle dependency as part of its drive to come to terms with climate change.

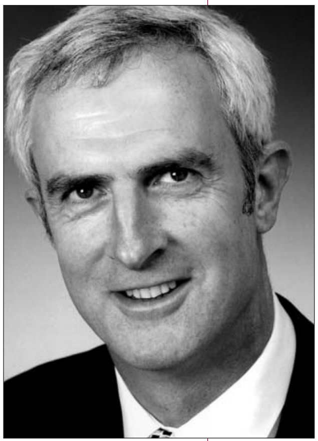
Further work to develop this analysis is underway and during 2006 the following tasks will be completed:

- Extending the property types to provide more detailed sub-division – for example Central London offices is at present a single property type and this will now be sub-divided to allow analysis of different types of offices determined, for instance, by age, size and form of letting.
- Unpicking the sustainability scores for particular types of property to reveal the key drivers and the extent to which these drivers cover matters that are within the management control of the fund manager.
- Comparing a fund's portfolio score with the quality of its management of sustainability factors, such as energy consumption and waste management, to see whether such management is likely to enhance or detract from performance.
- Examining the factors of risk within the performance of property to see whether the rather narrow conventional measure of beta can be improved upon.

Finally, it should be noted that while this analysis is clearly made in terms of the broad agenda of sustainability – economic, social and environmental – it is possible to run it with either an emphasis on, or entirely on, those matters that relate more specifically to climate change, the area in which there is likely to be the greatest amount of government regulation and intervention. Indeed, this exercise has been run for one of the syndicate members and the focus upon climate change factors alone does alter the outcomes of the analysis.

Together, these initiatives give an indication of the growing importance of corporate responsibility, socially responsible investment, responsible property investment and risk management amongst property companies and institutional investors. In time, they will, no doubt, also lead to investment practice that will seek to add and sustain value in circumstances that are truly uncertain.

Real estate and corporate social responsibility



Dr Angus McIntosh, King Sturge

The concept of corporate social responsibility (CSR) is accelerating thoughout the business world. It encompasses how companies manage the business process to produce an overall positive impact on society. For instance, the film 'Super Size Me' has impacted radically on McDonald's in terms of both customers and shareholders. In recent weeks, other major companies have also revealed their CSR strategies. The property investment industry needs to take note!

Fair governance and corporate social responsibility

The concepts of CSR and socially responsible investment (SRI) are rooted in the Christian Quaker movement and in more recent decades have found expression in movements like the boycott of South African goods in opposition to apartheid. Both Cadbury and Barclays Bank (originally Quaker companies) withdrew from South Africa in the 1970s and 1980s. What is new is the manner in which companies, including HSBC, Unilever, BP and Ford, are increasingly embracing the CSR principles.

The screening approach of excluding investment is being replaced by engagement and advocacy between investors and government over social concerns. Corporate reporting now places an increasing obligation on companies to make their policies explicit in terms of CSR, which, in turn, is leading to the perception that strong implementation of fair policies may lead to increased competitive advantage.

This case was made strongly by the Sustainable Construction Task Force (2001) who argued that a lack of attention to sustainability, including corporate social responsibility and 'human well-being', is likely to result in a decreased reputation and increased risk to profitability.

Human well-being

There are several strands to human well-being, ranging from issues such as the quality of the environment in which people operate to matters of physical protection and security. On a global scale, it embraces the right to self-determination and political freedom; on a micro scale it encompasses the right to live without fear of attack in safe city streets.

Another important aspect of human well-being is that of health and education. These dominate the human development indicators published by the United Nations Development Programme (http://hdr.undp.org) that lists the indicators of human well-being as follows:

- Life expectancy, including both at birth and overall. This is a surrogate for health.
- Education, including participation rates at both secondary and tertiary levels, and adult literacy.
- Gross domestic product (GDP) per head.

While the composition of the index is not without its critics, it does demonstrate the emphasis placed on health and education as measures of well-being.

Worker issues

Worker issues are closely linked to human well-being and concern fair remuneration, as well as for example health and safety in the workplace and working hours. With global trade, the issue of worker protection from exploitation is no longer a domestic matter.

The UK government's response to social sustainability is embodied within its policy documents (www.sustainable-development.gov.uk) using indicators that encompass:

- Output
- Employment
- Education
- Housing
- Climate change
- Road traffic
- Wildlife
- Waste
- Investment
- Poverty and social exclusion
- Health
- Crime
- Air quality
- River water strategy
- Land use

As noted in **Building Sustainability in the Balance** by McIntosh, Sayce & Walker (Estates Gazette, 2004), the article seeks to measure, on a year-by-year basis, the way in which government initiatives are leading to progress in these areas.

From a built environment perspective, some indicators such as housing, climate change and road traffic have clear implications while measures such as crime also relate to building design and layout. Waste can be seen in terms of the impact of design on waste disposal as well as seeing the construction industry as one of the key producers of waste during the building process.

Accounting for social sustainability

The early development of the sustainability agenda was strongly linked to that of environmentalism. It is only much more recently that social issues have been added to this and the economic issues to create the triple bottom line (social, economic and environmental sustainability). It follows that matters of accounting for social sustainability are also of recent origin. The Association of Chartered Certified Accountants (www.acca.co.uk) has, for example, made awards to companies in connection with the quality of their environmental accounting since 1991, and for full sustainability accounting since 2001.

Another manifestation of the role of social responsibility within the accounting process is the development of both the Dow Jones Sustainability Index and the FTSE4Good Index. Companies without sound social accounting procedures to implement related policies are unlikely to meet the criteria for inclusion within these indices.

The development of social accountability has lead to a range of initiatives such as the well-known Investors in People to AA1000 which requires organisations to demonstrate how social sustainability is not only accounted for but embedded within an organisation. King Sturge coming 16th in The Sunday Times Best 100 Companies to Work For (as logged by its employees), is another manifestation of this trend.

Social sustainability: from macro to micro concerns in urban development

The definition of social sustainability above, and the issues it raises, can be viewed as macro concerns for policy makers at town, national and international level. They are focused on people concerns and the actual iconic measure of the building is frequently not really addressed. It is the clustering of building into a specified identified 'place' that has primarily attracted the policy makers.

At a micro-level, social sustainability has been increasingly identified as synonymous with the drive for CSR. This is no longer an option in many cases, with financial institutions now obliged to have CSR policies and many other organisations seeing it as a matter of risk reduction and competitive advantage.

Implementation, at the level of individual decision-making, is more problematic. For example, investors with their commitment to CSR can track their share performance through FTSE4Good but they are not yet able to track their property investments as established tools do not yet exist.

Recent converts

Although a number of major property companies have had CSR polices for some while (for example Hammerson and Slough Estates) recent major announcements demonstrate their increasing importance.

Ford Motor Company recently announced its Greener Miles programme, encouraging owners to buy carbon offsets to cover vehicle usage.

In October 2005, the CEO of Wal-Mart declared he wanted his company supplied with 100% renewable energy, to create zero waste and sell products that 'sustain our resources and environment'.

In May 2006, Tesco launched its 10-point plan for CSR, including halving energy use by 2010, doubling rubbish recycling, helping small suppliers and selling more local produce.

In the same month, J Sainsbury also declared it wanted to source more of its products from local suppliers, rather than airfreight food from other parts of the world.

In the built environment, partly to win hearts and minds, but also to obtain planning permission, both Gazeley and ProLogis have developed and are now constructing Eco Template warehouses which aim to capture grey water and use solar energy.

Kofi Anan, Secretary General of the UN, launched the Equator Principles for CSR investment and the Global Compact concept, at the Davos Economic Summit in 2000. ABN AMRO plus Morley Asset Management (who own Igloo – the urban property ethical development fund) signed up a few years ago. The Church Commissioners, responsible for a lot of real estate, has refrained from investing in the likes of gambling, media, advertising and pornography for many decades.

Being socially responsible is not a new concept, but the idea of CSR is now taking on a more urgent imperative. Without it, corporates may lose customers and suffer adverse reactions from the media and shareholders. For the property investment market, without CSR it may be more difficult to obtain planning permission, and investors may also shy away from funds not perceived as ethical or those lacking a clear CSR policy.

Back to the future: oil, energy and real estate

Freelance journalist Tim Horsey pulls together the highlights from a recent IPF lecture held in London.

Chris Taite believes that current trends in energy use are unsustainable, and that this will have significant impacts on the UK property sector over the medium and long term. He suggested that those sectors that are currently forecast to perform well over the next five years, such as out-of-town retail parks, leisure, retail warehouses and business parks, are likely to fare less well over an energy-sensitive medium-term horizon, while all town centre uses and residential property are likely to perform much better. This view is based on research by environmental consultants Upstream, who have started to benchmark property sectors in terms of their sensitivity to different ecological impacts.

Taite painted a gloomy picture of the long-term outlook for energy, suggesting that "all energy costs will have to rise significantly in order to reflect the sector's fundamental economic, political and environmental pressures, with property investors being forced to address sustainability issues in order to preserve value." From Grosvenor's 300-year perspective on property markets, the next 50 years could be the most challenging.

The property sector is directly and indirectly affected by many aspects of energy use. CO_2 emissions are heavily affected by road transport, which is also a big influence on the property sector, while manufacturing, the construction sector and residential energy users all have big impacts on property demand. Car use affects the property sectors to varying degrees: a study by King Sturge and MORI on car use has found that travel to and from work is easily the biggest energy consumer, followed by leisure and shopping trips.

Taite's view of energy prospects was however at odds with the prognosis of the two other speakers at the meeting. Andrew Burrell suggested that the recent volatility of oil price movements has not generated the macro-economic upheavals once feared. This is mainly because higher oil prices have been recycled into stronger demand amongst oil-producers for the output of non-producers, while low long-term interest rates have cushioned recent shocks. Burrell now sees oil prices reducing in "an orderly price correction as global demand recedes."

Burrell thinks there is an enduring belief in the UK that oil price shocks result in recession, based on the bitter experience of the 1970s. He sees the current situation as very different, with the rise in prices due chiefly to growing demand from industrialising nations like China and India. There, manufacturing forms a high share of GDP compared to the mature economies, and oil is a much more significant cost. These economies should slow down in the near future, leading to a correction in the oil price.

The impact of oil price rises has also been moderated by central banks working to accommodate inflation, while increased savings have helped by pushing long-term bond rates very low. Nevertheless, UK consumers are likely to feel a squeeze on real incomes from sharp rises in utility bills on top of already high debt-servicing costs.

In the medium-term, Burrell believes that oil prices should move back towards $50 a barrel but that, given the current political situation, sudden lurches are quite likely. Oil supplies are relatively difficult to predict, but overall a correction downwards is probably more likely than the reverse. Economies with a high oil intensity of GDP, like Korea, Brazil and USA, would be likely to gain most from a fall in prices, while Russia would probably benefit most were prices to rise further.

Dr Leo Drollas reinforced this view, stating that oil prices are at current levels due to tight short-term market conditions, and not because oil supply is reaching its peak. In a rational world, oil prices should fall over the medium-term, as long as oil producers invest enough to ensure supplies reach their potential. He does, however, see considerable threats to supply from political uncertainty in the Middle East.

His organisation predicts that conventional oil supplies will not reach their peak until 2022, and he does not believe that there is a medium-term danger of oil supply crisis from a lack of potential reserves. In the short-term however, sudden rises in demand can cause problems, as there is currently little spare oil capacity, just 3% of output, a level that would cause problems in most other industries. However, in 2005 the level of growth in increase for the demand for oil started to decelerate, growing by only a third of its 2004 rate, due to the adjusting effect on demand of the price rise itself.

Dr Richard Barkham, Group Research Director at Grosvenor, who chaired this meeting, believes that "real estate professionals need to get behind both the reality and the rhetoric of the energy debate because both have implications for property returns."

Lecture speakers

Andrew Burrell, Experian Business Strategies

Chris Taite, Grosvenor Investment Management

Dr Leo Drollas, Centre for Global Energy Studies

Chairman: Dr Richard Barkham, Grosvenor

The presentations from this event are available to members in the members' area of **www.ipf.org.uk**

IPF Consensus Forecasts May 2006

The total return forecast of 13.4% for 2006, up from the 11.2% reported in the April 2006 survey and up from the 8.6% in the November 2005 survey, shows the impact of the yield reductions in the early part of the year. The average forecast for 2007 is also marginally up to 7.4% from the previous figure of 7.1%, largely built off better rental value growth prospects. For 2008, the consensus outlook is unchanged with a total return of 6.2%. Over the five years 2006 to 2010 the consensus is for a return of 8.0% pa, up from 7.7% pa in the February forecasts, implying average total returns of about 6.6% pa in the two years 2009 to 2010. Thus, the outlook is for a further five years of real property returns, albeit at lower levels than 2004 and 2005.

For the second quarter in succession there is considerable evidence of strong differences about the yield outlook for 2007 and 2008. Once again this divergence is illustrated by the views on capital values, with a significant number of forecasters expecting capital values to fall in 2008. The implication is that a minority of forecasters expect yields to move up in 2008. For investors, capital values shifts are only one part of total return, and the relatively high income return from property will offset these falls in capital values. For lenders these yield shifts may be more of a concern.

The demand for investment properties remains very strong, with funds aimed at small investors continuing to attract large inflows of capital. Many investors are increasing property weightings in their portfolios. However, the uncertainty about the outlook for property yields and capital values could, in time, reduce the demand and weight of money overhanging the market.

Key points

The total return forecast for 2006 has again increased, with an outlook of real property returns for the next five years.

- Total return in 2006 forecasted at 13.4%, up from 11.2% since the last survey.
- The average total return forecast is 8.0% pa for the next five years.
- Average all property rental value growth is 3.0% pa for 2006 to 2010 (inclusive).
- As with the last survey, there is evidence that a minority of forecasters expect property yields to increase during 2008, with some forecasts of yield increases in 2007.
- A minority of forecasters expect capital values to be under threat in 2008.
- London offices market recovery widely forecasted, with rental value growth of over 6.4% pa in West End offices and 6.0% pa in City offices for the next five years.
- For 2006, offices are forecasted to show the strongest rental value growth of 4.2%, on the back of strong rental value growth in central London.
- The average forecast is for relatively stable and sustained retail warehouses rental value growth in 2006, 2007 and 2008.
- Some forecasters remain pessimistic about the 2007 and 2008 prospects for standard shops, shopping centres and industrial with forecasts of falls in rental values or static rental values.
- Over the five-year period 2006 to 2010 (inclusive), offices are forecasted to show strongest rental value growth at 4.6% pa, followed by retail warehouses at 3.5% pa. Standard shops, shopping centres and industrial continue to offer lower than inflation matching rental value growth on the five-year view.

Recovery in office returns strengthens.

- Sector total return forecasts place offices, driven by strong central London performance, as the top performer in 2006 giving 16.0%, closely followed by retail warehouses at 13.1%. City offices may perform spectacularly in 2006, with one forecast of a return of 34.0%, built off rising rents and falling yields.
- On the five-year view, offices are the best performing sector at an average total return of 9.6% pa.
- West End (10.5% pa) and City (10.6% pa) offices are expected to outperform all five of the main sectors on the five-year view.
- The weakest sector is likely to be retail, with standard shops and shopping centres reflecting concerns about the deteriorating outlook for the consumer.
- All sectors will give real returns for 2006 to 2010.

Significant minority of forecasts imply that yields will rise in 2007 and 2008

- The capital value forecasts are generally weak for 2008. With the rental value growth forecasts, this implies property yields will move up in 2008.
- The diversity of views should add further impetus to the use of sector property derivative contracts for tactical asset allocation shifts.

Figure 1: Average rental growth

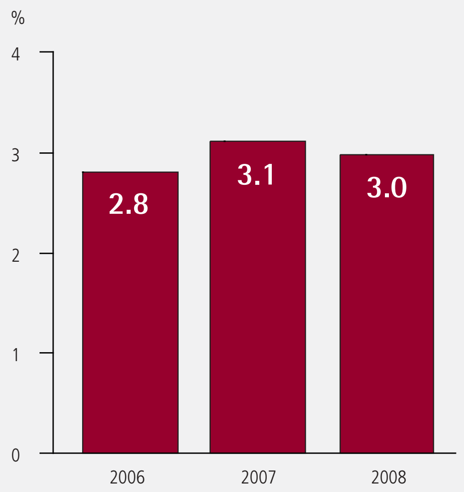
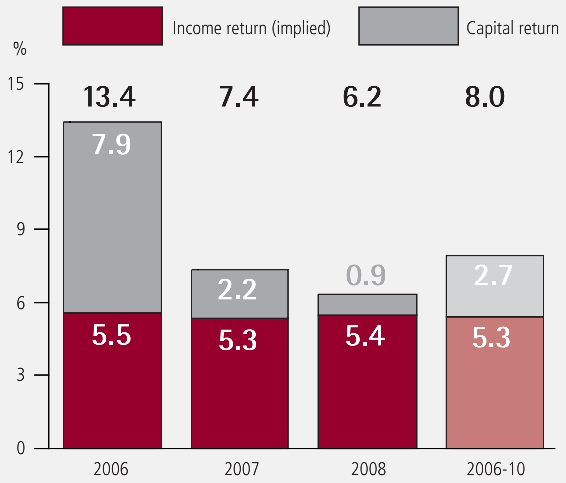


Figure 2: Average total returns



All property rental value growth forecasts

The average forecast is for 2.8% rental value growth in 2006, a slight increase on the February forecast of 2.5%. For 2007, the average forecast is for 3.1% rental value growth, up from the 2.7% forecast last time.

Thereafter, the consensus is unchanged with rental value growth of 3.0% in 2008. The annual average for the five years 2006 to 2010 has increased 3.0% pa. Thus, the consensus outlook is for marginal real rental value growth for five years, when set against an inflation expectation of 2.5% pa.

All property total return forecasts

The consensus for 2006 has strengthened with an average of 13.4% total return forecast.

Thereafter forecasters look for a slow down for 2007 and 2008, with just 7.4% and 6.2% total returns respectively. All sectors, except offices, have some forecasts of falling capital values for 2008. On average, capital growth is expected almost to disappear in 2008.

All Property survey results by contributor type
(Forecasts in brackets are February 2006 comparisons)

Figure 3: Property advisors and research consultancies (14 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
Maximum	4.0 (3.6)	4.4 (4.0)	4.8 (5.0)	15.0 (13.0)	5.9 (3.8)	4.3 (3.0)	20.2 (16.0)	10.9 (9.0)	9.2 (8.4)
Minimum	2.4 (2.1)	2.7 (1.9)	2.2 (2.0)	2.7 (2.7)	0.1 (-0.1)	-1.1 (-1.9)	8.4 (8.4)	4.8 (4.8)	3.8 (3.6)
Range	1.6 (1.5)	1.7 (2.1)	2.6 (3.0)	12.3 (10.3)	5.8 (3.9)	5.4 (4.9)	11.8 (7.6)	6.1 (4.2)	5.4 (4.8)
Median	3.0 (2.6)	3.1 (2.8)	3.3 (3.2)	7.4 (5.5)	2.2 (1.7)	1.7 (1.6)	12.8 (11.0)	7.8 (7.1)	7.4 (7.0)
Average	**2.9 (2.7)**	**3.2 (2.9)**	**3.3 (3.2)**	**7.3 (6.0)**	**2.3 (1.7)**	**1.8 (1.3)**	**12.8 (11.3)**	**7.5 (7.1)**	**7.3 (6.7)**

Figure 4: Fund managers (15 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
Maximum	3.2 (3.1)	3.8 (3.4)	4.5 (4.4)	11.1 (9.4)	4.5 (5.1)	3.7 (3.9)	16.5 (15.1)	9.5 (10.1)	8.6 (8.7)
Minimum	1.5 (1.4)	1.6 (1.5)	1.8 (1.8)	4.1 (1.0)	-1.0 (-3.0)	-6.0 (-7.0)	9.8 (7.0)	4.0 (3.0)	0.0 (-1.0)
Range	1.7 (1.7)	2.2 (1.9)	2.7 (2.6)	7.0 (8.4)	5.5 (8.1)	9.7 (10.9)	6.7 (8.1)	5.5 (7.1)	8.6 (9.7)
Median	2.6 (2.4)	2.7 (2.7)	2.4 (2.7)	7.8 (5.2)	2.0 (1.1)	0.0 (0.0)	13.5 (10.6)	7.0 (6.5)	5.3 (5.4)
Average	**2.5 (2.3)**	**2.7 (2.5)**	**2.7 (2.6)**	**8.1 (5.4)**	**1.7 (0.9)**	**-0.3 (-0.2)**	**13.6 (10.9)**	**6.9 (6.4)**	**5.1 (5.2)**

Figure 5: Equity brokers (4 contributors)																		
	Rental value growth %						Capital value growth %						Total return %					
	2006		2007		2008		2006		2007		2008		2006		2007		2008	
Maximum	3.4	(3.7)	4.0	(3.9)	3.8	(4.8)	9.8	(9.0)	4.0	(5.0)	3.8	(3.8)	15.0	(17.0)	10.0	(14.0)	8.4	(10.0)
Minimum	3.0	(1.8)	3.5	(2.0)	3.0	(2.0)	9.0	(2.2)	2.0	(1.6)	0.0	(0.0)	14.5	(7.8)	7.8	(7.1)	5.0	(5.0)
Range	0.4	(1.9)	0.5	(1.9)	0.8	(2.8)	0.8	(6.8)	2.0	(3.4)	3.8	(3.8)	0.5	(9.2)	2.2	(6.9)	3.4	(5.0)
Median	3.2	(2.8)	3.9	(3.0)	3.1	(3.0)	9.1	(6.8)	3.6	(2.0)	2.0	(2.3)	14.9	(12.8)	8.6	(8.0)	7.4	(8.0)
Average	**3.2**	**(2.7)**	**3.8**	**(2.9)**	**3.3**	**(3.3)**	**9.3**	**(5.9)**	**3.3**	**(2.9)**	**1.9**	**(2.2)**	**14.8**	**(12.1)**	**8.8**	**(9.2)**	**7.0**	**(8.0)**

Figure 6: All forecasters (33 contributors)																		
	Rental value growth %						Capital value growth %						Total return %					
	2006		2007		2008		2006		2007		2008		2006		2007		2008	
Maximum	4.0	(3.7)	4.4	(4.0)	4.8	(5.0)	15.0	(13.0)	5.9	(5.1)	4.3	(3.9)	20.2	(17.0)	10.9	(14.0)	9.2	(10.0)
Minimum	1.5	(1.4)	1.6	(1.5)	1.8	(1.8)	2.7	(1.0)	-1.0	(-3.0)	-6.0	(-7.0)	8.4	(7.0)	4.0	(3.0)	0.0	(-1.0)
Range	2.5	(2.3)	2.8	(2.5)	3.0	(3.2)	12.3	(12.0)	6.9	(8.1)	10.3	(10.9)	11.8	(10.0)	6.9	(11.0)	9.2	(11.0)
Median	2.8	(2.5)	3.0	(2.8)	3.1	(3.0)	7.5	(5.2)	2.1	(1.5)	1.1	(1.0)	13.5	(10.7)	7.7	(7.0)	6.5	(6.4)
Average	**2.8**	**(2.5)**	**3.1**	**(2.7)**	**3.0**	**(3.0)**	**7.9**	**(5.7)**	**2.2**	**(1.5)**	**0.9**	**(0.7)**	**13.4**	**(11.2)**	**7.4**	**(7.1)**	**6.2**	**(6.2)**
Std. Dev.	0.5	(0.5)	0.7	(0.6)	0.8	(0.9)	2.6	(2.5)	1.5	(1.6)	2.0	(2.1)	2.4	(2.4)	1.5	(1.8)	1.9	(2.1)

Notes

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

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

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

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

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

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

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

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

Survey results by sector

Figure 7: Offices												
	Rental value growth %				Capital value growth %				Total return %			
	2006	2007	2008	2006-10	2006	2007	2008	2006-10	2006	2007	2008	2006-10
Maximum	9.8	8.1	7.1	6.6	17.1	9.7	9.7	7.1	23.0	15.2	14.8	12.3
Minimum	2.1	3.5	2.6	3.1	2.6	0.0	-2.0	-1.8	9.1	6.0	3.9	4.0
Range	7.7	4.6	4.5	3.5	14.5	9.7	11.7	8.9	13.9	9.2	10.9	8.3
Median	3.6	4.7	5.1	4.4	9.0	3.9	2.0	4.0	15.3	9.6	7.9	9.5
Average	**4.2**	**5.2**	**5.1**	**4.6**	**10.1**	**4.6**	**2.7**	**4.1**	**16.0**	**10.1**	**8.1**	**9.6**

Figure 8: Industrial												
	Rental value growth %				Capital value growth %				Total return %			
	2006	2007	2008	2006-10	2006	2007	2008	2006-10	2006	2007	2008	2006-10
Maximum	2.2	2.5	4.3	2.8	10.0	4.5	2.7	3.9	15.9	10.2	8.3	9.6
Minimum	-0.1	0.2	0.0	0.8	1.5	-2.1	-3.0	-1.7	7.6	3.6	3.9	4.3
Range	2.3	2.3	4.3	2.0	8.5	6.6	5.7	5.6	8.3	6.6	4.4	5.3
Median	1.4	1.6	2.1	1.7	5.8	1.2	0.5	2.0	12.0	6.9	6.4	8.1
Average	**1.3**	**1.6**	**1.9**	**1.8**	**5.9**	**1.2**	**0.4**	**1.8**	**12.1**	**7.2**	**6.5**	**7.8**

Figure 9: Standard shops

	Rental value growth %				Capital value growth %				Total return %			
	2006	2007	2008	2006-10	2006	2007	2008	2006-10	2006	2007	2008	2006-10
Maximum	2.3	2.9	3.1	2.7	10.8	3.5	2.5	3.0	15.7	8.1	7.3	8.0
Minimum	0.5	0.0	0.0	0.7	0.8	-2.0	-7.5	-1.3	5.8	2.9	-3.1	3.3
Range	1.8	2.9	3.1	2.0	10.0	5.5	10.0	4.3	9.9	5.2	10.4	4.7
Median	1.6	1.7	1.5	1.6	5.3	0.2	-0.1	1.4	10.4	5.0	4.9	6.5
Average	**1.5**	**1.5**	**1.6**	**1.6**	**5.5**	**0.4**	**-0.3**	**1.4**	**10.4**	**5.1**	**4.5**	**6.3**

Figure 10: Shopping centre

	Rental value growth %				Capital value growth %				Total return %			
	2006	2007	2008	2006-10	2006	2007	2008	2006-10	2006	2007	2008	2006-10
Maximum	4.4	3.8	4.0	3.9	14.6	5.8	2.5	4.2	19.6	10.8	8.0	9.1
Minimum	0.5	-0.1	0.0	0.4	2.0	-4.4	-4.0	-4.3	7.3	0.8	1.0	1.3
Range	3.9	3.9	4.0	3.5	12.6	10.2	6.5	8.5	12.3	10.0	7.0	7.8
Median	2.5	2.2	2.2	2.1	5.9	1.0	0.3	2.1	11.3	6.1	5.4	7.2
Average	**2.6**	**2.1**	**2.0**	**2.2**	**6.8**	**0.9**	**0.3**	**1.8**	**12.0**	**5.9**	**5.3**	**6.9**

Figure 11: Retail warehouse

	Rental value growth %				Capital value growth %				Total return %			
	2006	2007	2008	2006-10	2006	2007	2008	2006-10	2006	2007	2008	2006-10
Maximum	5.0	4.3	4.9	5.9	20.2	5.4	5.0	6.3	24.6	9.8	9.3	10.5
Minimum	2.0	2.2	1.8	1.9	2.8	-4.0	-6.0	-4.0	7.5	1.0	-2.0	0.9
Range	3.0	2.1	3.1	4.0	17.4	9.4	11.0	10.3	17.1	8.8	11.3	9.6
Median	3.5	3.1	3.2	3.5	7.8	2.5	1.5	3.5	12.5	7.0	6.0	7.6
Average	**3.5**	**3.3**	**3.3**	**3.5**	**8.4**	**2.4**	**1.3**	**3.4**	**13.1**	**7.0**	**5.9**	**7.9**

Figure 12: All property

	Rental value growth %				Capital value growth %				Total return %			
	2006	2007	2008	2006-10	2006	2007	2008	2006-10	2006	2007	2008	2006-10
Maximum	4.0	4.4	4.8	4.2	15.0	5.9	4.3	5.1	20.2	10.9	9.2	11.0
Minimum	1.5	1.6	1.8	1.7	2.7	-1.0	-6.0	-2.7	8.4	4.0	0.0	3.0
Range	2.5	2.8	3.0	2.5	12.3	6.9	10.3	7.8	11.8	6.9	9.2	8.0
Standard deviation	0.5	0.7	0.8	0.6	2.6	1.5	2.0	1.5	2.4	1.5	1.9	1.4
Median	2.8	3.0	3.1	3.0	7.5	2.1	1.1	2.7	13.5	7.7	6.5	8.1
Average	**2.8**	**3.1**	**3.0**	**3.0**	**7.9**	**2.2**	**0.9**	**2.7**	**13.4**	**7.4**	**6.2**	**8.0**

Figure 13: Sector summary

	Average rental value growth %				Average capital value growth %				Average total return %			
	2006	2007	2008	2006-10	2006	2007	2008	2006-10	2006	2007	2008	2006-10
Office	4.2	5.2	5.1	4.6	10.1	4.6	2.7	4.1	16.0	10.1	8.1	9.6
Industrial	1.3	1.6	1.9	1.8	5.9	1.2	0.4	1.8	12.1	7.2	6.5	7.8
Standard shops	1.5	1.5	1.6	1.6	5.5	0.4	-0.3	1.4	10.4	5.1	4.5	6.3
Shopping centres	2.6	2.1	2.0	2.2	6.8	0.9	0.3	1.8	12.0	5.9	5.3	6.9
Retail warehouse	3.5	3.3	3.3	3.5	8.4	2.4	1.3	3.4	13.1	7.0	5.9	7.9
All property	**2.8**	**3.1**	**3.0**	**3.0**	**7.9**	**2.2**	**0.9**	**2.7**	**13.4**	**7.4**	**6.2**	**8.0**

Figure 14: West End offices

	Rental value growth %				Capital value growth %				Total return %			
	2006	2007	2008	2006-10	2006	2007	2008	2006-10	2006	2007	2008	2006-10
Maximum	18.5	11.2	11.0	9.0	25.5	14.3	10.0	10.3	30.0	18.6	13.9	14.4
Minimum	3.9	3.9	2.3	3.3	5.4	0.0	-3.4	-3.1	9.4	4.0	0.6	2.1
Range	14.6	7.3	8.7	5.7	20.1	14.3	13.4	13.4	20.6	14.6	13.3	12.3
Median	6.2	7.1	5.9	6.3	16.3	6.8	2.7	5.7	21.4	10.9	7.6	10.4
Average	**7.9**	**7.3**	**6.5**	**6.4**	**15.9**	**6.3**	**3.2**	**5.7**	**20.9**	**10.9**	**7.7**	**10.5**

Figure 15: City offices

	Rental value growth %				Capital value growth %				Total return %			
	2006	2007	2008	2006-10	2006	2007	2008	2006-10	2006	2007	2008	2006-10
Maximum	20.0	12.2	11.4	10.4	27.3	11.4	10.0	9.6	34.0	16.7	15.5	14.2
Minimum	1.5	4.8	2.1	3.9	3.7	1.0	-3.3	-2.5	9.2	6.0	1.2	3.0
Range	18.5	7.4	9.3	6.5	23.6	10.4	13.3	12.1	24.8	10.7	14.3	11.2
Median	4.5	6.8	7.2	5.6	11.8	5.5	2.8	5.5	17.3	11.3	8.4	10.5
Average	**5.9**	**7.4**	**7.2**	**6.0**	**12.9**	**5.9**	**3.6**	**5.3**	**18.7**	**11.4**	**8.9**	**10.6**

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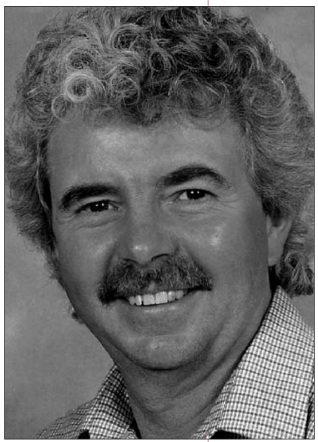
The UK commercial property lending market

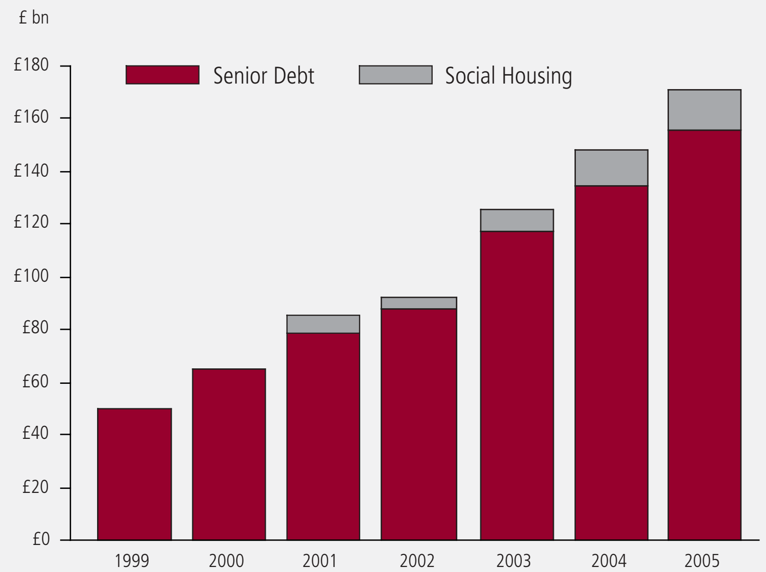


Bill Maxted, De Montfort University

De Montfort University has recently published the results of its survey for year-end 2005 into commercial property lending in the UK. These results were presented to IPF members in May. This research has been running since 1997. This article provides a summary of the research findings. A full copy of the report is available, price £250, from De Montfort University.

During 2005, the downward trend in property investment yields continued, accompanied by movements in the five-year swap rate that rose during the first quarter of the year, fell in the second quarter and then gradually increased during the remainder of the year. Thus lending conditions were overall more challenging during 2005 than in 2004. Despite these observations, the aggregated value of outstanding debt secured by commercial property increased by 16% during 2005 to an estimated size of between £164bn and £175bn at year end. The value of loans originated during 2005 of £66.1bn was an increase of 47% over the previous year and the single highest annual increase recorded by this research.

Figure 1: Aggregated value of outstanding debt reported to research



These volumes of lending appear to have been achieved by a further relaxation of lending terms; interest rate margins and fees reduced again for all property sectors and loan-to-value ratios increased, albeit relatively modestly in most cases. While these increases were constrained by low investment property yields, income to interest cover also generally reduced for all sectors. This reduced the scope for amortisation and resulted in some organisations being prepared to accept higher levels of residual debt exposure and to grant interest-only loans. Thus it would appear that many organisations in the market are accepting more risk for a reduced return.

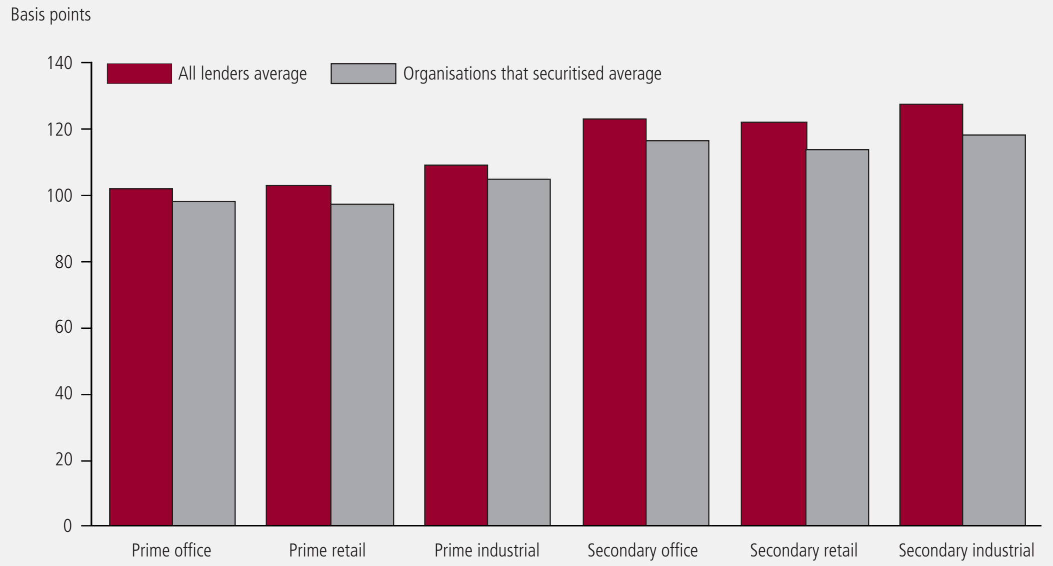
In response to these conditions, organisations are lending into a wider range of sectors to increase interest rate margin and return. During 2005, there was an increase in loan book allocations to residential, industrial and 'other' property types including mixed use developments, health care, infrastructure, and the public sector generally including education and student accommodation. Similarly, both the proportion and value of lending to commercial property development projects, including speculative development, increased during 2005.

In the same way, lenders are also adjusting their regional allocation of lending. There has been a shift in loan book allocations away from the higher value areas of London and the South East to other regions within the UK and there are also organisations that are following borrower requirements and lending into mainland Europe. There was also an adjustment in the profile of borrower/loan sponsors during 2005. The proportion of outstanding debt held by high net worth individuals has increased from 10% in 2004 to 16% in 2005. This is greater than the 10% held by institutional investors, equity and pension funds.

The single biggest impact on the commercial property lending market was that made by organisations that securitised loans into the CMBS market during 2005. The process of securitisation removes the risk associated with the debt from the balance sheet of the loan originating organisations. At the same time, efficient packaging and tranching of issues can reduce interest rate margins and increase loan-to-values for borrowers. Thus the emergence of organisations that are going to continue producing conduits for CMBS issues is a 'two-edged sword' for the UK lending market.

On the one hand, the risks of loan delinquencies and defaults are being removed from organisations operating within the lending market. On the other hand, non-securitising lenders are finding it difficult to compete with the more aggressive terms that can be obtained from CMBS issuers. The value of securitisations completed in 2005 by organisations that contribute to this research was £12.6bn. This was double the value recorded in any of the previous years by this research. German, North American and, more recently, UK lenders are all prominent players in this market. With 50% of organisations that contribute to this research intending to become and remain active in securitising debt, their impact will be both lasting and significant.

Figure 2: Comparison of margins



However, what appears to be aggressive lending practices needs to be viewed against a market that has remained relatively stable. There is no 'debt mountain' building up for repayment in any particular year and the level of loan defaults and breaches of financial covenant remain very small in relation to the value of outstanding debt. Organisations that have previously been some of the biggest players in the market have, more recently, reduced their activity while 71% of organisations insist on new loans being hedged against movements in interest rates.

The due diligence process of rating agencies in loan securitisations and organisations becoming Basle II compliant will also impose additional levels of loan scrutiny. Greater diversification of lending to different types of property and regionally throughout the UK will reduce the vulnerability of loan portfolios to either a downturn in specific sectors or geographical locations. Traditionally perceived sectors of high risk lending such as speculative development, while increasing in volume, still represent less than 4% of the value of outstanding loans. This is a completely different set of circumstances from those that existed in the early 1990s and, additionally, current interest rates remain much lower than those experienced in the past.

To conclude, with 89% of organisations that contribute to this research intending to increase the value of loan originations in 2006, the latent depth of the CMBS market and the introduction of Real Estate Investment Trusts, the supply of money into the sector is likely to increase. Consequently, there will still be competition to lend and pressure on lending terms. While many commentators suggest that, based on investment fundamentals, commercial property is over-valued and a market correction is due, in the short-term it is believed that the current market stability can be maintained by the supply of money. For the future, it is important that a rigorous approach and analysis is applied to new lending, so that if a correction were to occur it does not undermine that stability.

Financial engineering: the use of project equity

The IPF Investment Education Programme contains a module 'Property Finance and Funding' which examines in detail funding possibilities for property projects together with other aspects of property finance. Patrick Harnan is a director of Kingfisher Property Finance and is the module leader of this course. This module is available to be taken individually and next runs 17 to 19 July 2006. The full IPF diploma course of eight modules commences in October 2006. It includes two new modules, Property as an Asset Class in e-learning format, and Indirect Property Investment. For information please go to the education section of the IPF website www.ipf.org.uk

The use of financial engineering in commercial property investment and development is a vital tool for investors seeking to extract the best returns from any given project. There is a wide variety of finance available to the UK property market and the competition to place money is stronger than ever. This is not just at a senior debt level but includes mezzanine finance and project equity available on a project-by-project basis. An investor or developer can use these options to assemble a financing arrangement, which both enhances returns and facilitates maximum use of a limited equity base.

The recently published research by De Montfort University (as mentioned on pages 18 to 19) covering the UK commercial property lending market at the end of 2005, shows that both the amount and the availability of senior debt to the UK commercial market is at record levels. The survey finds that average margins are down in all sectors of the commercial property market. Prime retail and office margins, around 110% at the end of 2004, had reduced to just over 100% by the end of 2005. Over the same period, loan to values are up with lenders prepared to lend more against investment properties in all sectors. Most sectors have seen average loan to values increase by 1 to 2% during 2005 and income cover allowing this looks set to increase. The vast majority of lenders are seeking to increase their exposure to commercial property, with 89% of all lenders intending to increase their loan book during 2006. This isn't a surprise to those close to the market.

With exposures increasing and interest cover diminishing it looks as if lenders are taking riskier positions to win business. However, one might argue that the lender's risk is managed by the increasing expertise of both the banks and their borrowers in understanding and dealing with the underlying asset. This seems to be underpinned by a very tiny percentage of loans running into problems. For those with a limited equity base, there is now clear potential to add competitively priced equity to more orthodox senior debt facilities in multi-layered financing arrangements. This allows property companies and individuals to gear up like never before and target bigger assets that may have previously been out of reach.

Patrick Harnan, Kingfisher Property Finance

As banks target the property sector because of the relatively high returns and the lack of volatility, their property expertise has also increased. Consequently, this expertise is now being used on a wide scale basis to improve returns on their property exposure by making a small percentage of their loan books available for higher risk, higher return scenarios. Alongside there is an increasing number of specialist equity investment vehicles. They are created to invest equity alongside proven and talented asset managers in good opportunities. As such, there is a fairly diverse and very competitive debt and equity pool. A would-be investor can use this to target larger acquisitions or to grow quickly.

These equity investment vehicles, typically known as opportunity or venture funds, are opportunity led, often without any formal preconceived strategy regarding property type, sector or location. A good number of these are now well established and new funds continue to join the market. They tend to come to the market after a period of fund raising and typically have an investment window of circa 18 months, following which investments are managed with their partners through to exit some two to four years later. As a consequence, while equity finance is becoming more readily available, the financiers providing it are constantly changing due to their preference of investing the funds over a short space of time.

Generally, these equity financiers have no structural preferences and are able to adjust their stance to the requirements of a particular asset manager or opportunity. They can invest in joint ventures, limited partnerships and limited liability partnerships on or offshore. Most, however, do have minimum return requirements that are assessed in different ways and the ability to recreate these approaches is a useful method to decide which provider might be the most suitable. As a result of these minimum return requirements, the criteria for successful placement of equity finance is more demanding than senior debt. The presentation to equity providers must be focused on their requirements and generally needs to include the following characteristics:

- A specific opportunity with good, clear, asset management values to add value.
- A promoter or asset manager with the necessary expertise and a clear demonstrable track record.
- A business plan over a three to five-year time scale. Generally this business plan needs to be based on solid assumptions and show a general equity return in excess of 20% pa.
- Some, albeit small, co-investment.

Investments are normally arranged with the equity requiring a pro-rata priority return with an agreed profit share thereafter. The asset manager can expect to be incentivised in such a way that a greater share of profit after the priority return is available to them on a promote structure. While the business plan is running its course, the asset manager can often expect fees from the project in order to recover their costs.

With the increasing level of equity providers in the market, equity finance is becoming as much a commodity as debt finance. The difficulties in sourcing it arise because of the constantly changing market as funds are raised and then invested together with the pressures that the wider commercial property market is placing on pricing. There is also the difficulty in demonstrating that the project provides the returns because of the increased base price of the stock from yield compression. However, as yields are compressed within the wider commercial market and the price expectations of vendors rise, equity providers have, so far, been swift to follow this and reduce their base target returns accordingly. This is not a precise or pre-meditated move on their part but has been necessary to continue investing their capital. Clearly, there is a limit as to how far they will go to satisfy their own requirements and a number are turning their attention to mainland Europe in search of higher returns.

Despite this, there are still some excellent sources of equity on a project specific basis. To help establish where the project returns might be, the ability to understand where senior debt risk stops and mezzanine or equity finance risk begins is all important. Furthermore, an appreciation of how different financiers at different levels of the returns framework will perceive and price risk helps the investor to understand how asset management opportunities can be priced. Lastly, understanding how the various finance tranches can be pieced together and organised in such a way to maximise returns, while still allowing some freedom of control for the asset manager, should not be forgotten if the asset manager is to pursue its strategy and use its property expertise to best advantage.

Project equity looks a feature of the commercial property financing environment for years to come. It presents interesting opportunities to asset managers and smaller property companies seeking to increase their exposure. Without doubt it increases the risk and volatility of the investor’s returns but this can be balanced by spreading the risk across a number of projects. In theory, it points to a fragmentation of property ownership as there are no real boundaries to what an individual investor can invest in with the backing of substantial project equity. Typically, an asset manager with the right skills and opportunity can invest as little as 10% of the equity requirement (normally around 2 to 3% of the overall project cost) but there are circumstances where this can be reduced still further.

However, the availability of equity and the returns required to satisfy it need to be considered within the context of the wider commercial market. The expectations for both senior debt and equity providers need to tie in to the returns on offer and clearly, there may be a point where yields are compressed to a point where the mathematics of a deal fails to work. Transactions are more marginal than six months ago. Without doubt, well-honed financial engineering skills within a property investment context are of increasing importance if one is to take advantage of the finance options on offer. In a highly competitive market such as this, an investor needs to take advantage of every resource on offer in order to be successful.

How to insure your performance track record: get back to prime

Freelance journalist Tim Horsey pulls together the highlights from a recent IPF lecture held in London.

Opinions vary on whether UK property is red hot, white hot or on the verge of melt-down, but the best prospects may well now lie in prime assets, assuming that it's possible to get hold of them. Bullish Lord Matthew Oakeshott, Joint Managing Director of OLIM, believes that the UK property sector still offers value. He last spoke at an IPF meeting in November 1989, just before the last big crash, when he advocated the benefits of high income property as opposed to prime – a strategy that turned out to be very fruitful. Now, however, he sees the differential between high-yielding assets and prime as insufficient to justify the greater risk of secondary.

Bearish Gerald Blundell, Director of Risk Analysis for UK and Europe at LaSalle Investment Management, saw each of the last three property market crashes. He knows that property market bubbles are easy to recognise looking backwards, but far more difficult to identify from the middle of one. Perhaps the only certainty is that a bubble will happen eventually – the most important thing is therefore to minimise the damage when it happens. One of the best ways of doing this he believes is to focus strategy on sectors like standard retail units and offices outside London. These are traditionally more resistant to downturns, though they have also shown lower long-run performance.

Nick Ritblat, former Board Director of British Land, believes that property as a whole has transformed into a prime asset in recent years – to the extent that a continuation of the fall in yields to below the level of gilts has become completely possible and justifiable – and that there is really no reason to fear any kind of melt-down in the near future.

Oakeshott maintains that the continuing attraction of property lies in its fixed income stream, which is still on offer at a higher than fixed interest yield, even allowing for depreciation and cost of management. Rental markets are less volatile than in earlier times as inflation is low, and so a lower yield for property than the average for the last 40 years is now appropriate. Property yields look good value compared to gilts, as there is still growth potential in the market, though some of the more recently-launched property vehicles may actually be more expensive than they appear. This position will only be threatened if rental values suffer a sustained fall.

Oakeshott feels that comparing property and equities prospects is now a close call, with UK business profit and dividend growth likely to exceed property rental growth over coming years. But the property market is undoubtedly hot, in particular for indirect vehicles and derivatives, which are trading at significant premia relative to valuations.

Most crucially however, he also believes that the high-yielding areas of the property market are dangerous. Too many aggressive investors have chased highly-geared vehicles, based on the assumption that borrowing costs will always be lower than yields, and the banks are continuing to accommodate this fervour. Properties in poor locations with shaky tenants and short leases have indeed performed well, but due to the weight of money chasing them rather than a realistic assessment of their cash flow potential. The long decline in bond yields and short-term interest rates has now ended, so that time has now been called for positive property financing. He would rather be holding a well-located shop or warehouse at 5 to 6% than a secondary office on the fringe of a city or a clapped out industrial estate with vendor guarantees on the empty units for a few months, at 7%.

Oakeshott recognises that in the current market high-yielding properties are still performing, but it is important that those investors don't, in the words of one commentator, "confuse brains with a bull market." On the other hand experienced long-term investors may still be able to pick out one or two high-yielding assets with good long-term prospects. "Yearning for yield over borrowing costs has almost wiped out the premium for secondary over prime," says Oakeshott. "The time has come for investors to de-risk and de-gear their property portfolios."

Blundell's more bearish position is based on his analysis of fair value historically and against the other asset classes. One approach is to look at the level of property yields compared to their long-term average, although this is hazardous because yield series can only be taken back to the mid-1980s on a consistent basis. However, the current level of the IPD equivalent yield, adjusted for inflation, stands at 3.5%, which is around 15% below the 20-year norm.

Compared to other asset classes, property's yield looks competitive at present, but he believes that equities and bonds are also priced at a premium compared to their long-term averages. In addition, LaSalle uses the relationship between sale prices and previous valuations as an indicator of market temperature. At present, sale prices are running about 20% ahead of values, a margin even greater than in the boom of the late 1980s. And perhaps most strikingly, recent rates of increase in property values have greatly outstripped UK economic growth; this is something that historically only tends to happen in bubble markets.

Blundell sees many of the conditions that characterise bubbles as now in place, including an extension of credit in the sector, the development of new instruments (such as derivatives) and a move towards trading at the margin. But he believes that a true bubble market needs greater involvement from ignorant outsiders – though this may happen once REITs have been introduced. In addition, there has not yet been a surge in occupier markets, as usually occurs in property booms.

The event that pricks the bubble is notoriously difficult to predict. In the current climate it may be a sudden burst of irrational exuberance, especially if development takes off, or perhaps more likely the reversion of real bond yields to their long-run mean of

3%. Occupiers may fail to sustain rental growth expectations, or the flood of funds coming into property may dwindle to a trickle if capital starts to demand stronger fundamental growth prospects. But most likely, the crucial event will be one that no-one expects.

Blundell suggests a number of ways of avoiding the worst effects of the likely crash. Sectors like standard retail units and offices outside London are traditionally more resistant to downturns, though they have also shown lower long-run performance. Emerging sectors like 'suit-elling', student housing and infrastructure may also have lower volatility, but selling for cash should be a more reliable strategy. The only problem is that clients don't want to hear this advice when they have funds coming in.

Derivatives may offer an alternative way of offloading property exposure, but Blundell believes the risks inherent in such instruments are difficult to assess. The liquidity of derivatives is also difficult to analyse as many of the deals done so far have been between market makers, a trend reminiscent of the activity which supported the infamous London Fox market in the 1990s.

Blundell concludes that property is now overpriced, but that the market needs an extra magic ingredient to be transformed into a bubble.

In contrast, Ritblat believes that property is at last being treated as an asset class on a par with others, a trend that has helped boost institutional allocations in recent years. Moreover, he continues to be optimistic about prospects for the sector. He does not share the view that property should necessarily yield more than bonds, citing evidence from the 1950s when the yield gap worked in the other direction.

Changes in savings patterns, and in particular the pressure on individuals to make greater provision for their pensions, are likely to favour property over bonds because private individuals think they understand property better, and believe it will hedge against inflation and provide growth. In the end, professional pensions investors may also move away from bonds, given the need for growth, so that over the next 10 years both property and equities are likely to inherit some of the existing heavy exposure to bonds.

Innovation in the market should also help maintain its health. In this regard, Ritblat views derivatives as potentially more significant than REITs. Derivatives will allow investors to access property far more cheaply and without the risk associated with individual assets or vehicles, and create greater liquidity. In other markets, REITs have become the principal vehicles for property investment, both for individuals and for institutions. And he believes that the ability they give private individuals to gain access to property in relatively small allocations should prove very attractive.

In terms of wider economic factors, the UK economy appears to be in good shape, especially compared to the USA, but the latter always casts a long shadow internationally. Bond yields have been rising globally, unsettling markets and any areas of property that are financially driven; but Ritblat sees equity investment as ultimately more significant for real estate. UK equities have just experienced a serious correction, but the long-term outlook for the economy is strong and suggests that they are now fairly priced.

So why all the gloomy outlook? 19% total returns in each of the last two years have made everyone jittery. UK REITs are likely to be priced higher than bonds, and there is a question as to whether this will be sustainable. But Ritblat feels that the good returns of recent years have represented a justifiable period of catching up after a long period of under-pricing in the 1990s. Combined with the current consistently low inflation environment, property looks fairly priced. Property can now yield less than it has historically because all asset classes are yielding less than they were, mainly due to the amount of savings out there looking for investment opportunities.

Lecture speakers

Lord Matthew Oakeshott, OLIM

Gerald Blundell, LaSalle Investment Management

Nick Ritblat

Chairman: Mike Brown, Helical Bar

The presentations from this event are available to members in the members' area of www.ipf.org.uk

The IPF joint research programme 2003–2006

The IPF Educational Trust and IPF joint research programme has a number of current projects that we expect will complete and report over the coming months. These projects are constantly uncovering new, and interesting, dimensions to the original research questions.

The ongoing projects are:

- Behavioural influences on property stock selection decisions
- Index smoothing and the volatility of UK commercial revisited
- Diversification in property portfolios
- Planning policy and retail property market performance in English towns and cities
- Property derivative pricing guidance note
- Asset allocation in a modern world

Diversification

This project, which emphasises the important and subtle distinction between portfolio risk reduction and portfolio diversification, will launch at the IPD/IPF Annual Conference in Brighton on 30 November and 1 December 2006.

IPD/IPF Annual Conference

The IPF once again has a dedicated IPF research discussion and debate session on Friday 1 December, to round off the annual conference. Last year this was a huge success with 90 attending the session to hear the preliminary results of work in progress and contributed to shaping the future IPF research agenda. We will announce shortly on our website which projects are to be included.

The future: IPF Research 2006–2009

The Investment Property Forum is delighted to announce that it has secured external funding of £1 million to support the IPF research programme 2006–2009.

The IPF is very grateful for the farsighted support and commitment from the following 24 organisations.

Addleshaw Goddard, The British Land Company PLC, Credit Suisse, Deloitte, DLA Piper Rudnick Gray Cary UK LLP, Donaldsons LLP, Government of Singapore Investment Corporation, Grosvenor, GVA Grimley LLP, Hammersons PLC, Helical Bar PLC, Investment Property Databank, Kenmore Investments Ltd, Knight Frank LLP, Land Securities PLC, LaSalle Investment Management, Legal & General Property Ltd, Morley Fund Management Ltd, Nabarro Nathanson, Prudential Property Investment Managers Ltd, Quintain Estates & Development PLC, Scottish Widows Investment Partnership, Standard Life Investments Ltd and Strutt & Parker.

Charles Follows, IPF, Research Dorector

The new programme was launched at the IPF offices on Tuesday 6 June, at a reception held to thank the 24 supporters for their future commitment to IPF research.

The IPF continues to identify research topics and prepare suitable research briefs. It then either tenders the project brief, inviting competitive bids or, if appropriate, negotiates a suitable contract with a selected research provider.

In addition, the IPF warmly welcomes research proposals. We invite researchers, universities and other organisations to submit research proposals for consideration.

IPF research supports the IPF's wider objectives and mission, and follows a thematic structure:

1. Improve functioning and efficiency of the property investment market

- Vehicles and instruments
- Market structure
- Legal issues
- Tax issues
- Liquidity
- Investment management
- Risk management
- Valuation
- Regulation and governance
- Surveys and information

2. Ensure property receives a fair hearing with asset allocators

3. Inform debate at the highest levels

Forum news

New Chairman

Ian Womack, Managing Director, Property at Morley Fund Management, is now IPF Chairman, effective as of the IPF AGM which took place on 20 June 2006.

Ian graduated with an honours degree in Urban Land Economics in 1977 and is a Fellow of the Royal Institution of Chartered Surveyors. He was appointed to his current position at Morley in July 2000 having joined Norwich Union in 1980.

Ian joined the IPF management board in June 2002, taking an active role in the development of the vision for the organisation and the development of the IPD/IPF conference programme. He is not planning on ploughing a particular furrow but wishes to continue to develop the effective joint working relationships which deliver tangible results as seen in recent months.

Peter Freeman of Argent supports Ian as Vice Chairman.

Temporary staff changes at the IPF

I am sure you will join us in wishing our executive director, Amanda Keane, well as she leaves us for a short period of time to take maternity leave (effective as of 24 May – expected return date late October).

During this time, Vivienne Wootten becomes the Acting Executive Director and takes on the day-to-day responsibility for the running of the organisation. In addition, Sabrina Wisner now leads on our education initiatives and our new team member Claire Wakelin oversees membership and marketing initiatives.

Education

So far in 2006 the forum has run nine lectures, three workshops and a couple of technical briefings. We are in the process of putting together the autumn CPD programme so if you have any ideas please contact Sabrina Wisner on swisner@ipf.org.uk

We have a remaining workshop for this summer that still has space:

Understanding European commercial mortgage backed securities
Thursday 6 July, 6 to 8pm,
BDO Stoy Hayward LLP, 8 Baker Street, W1

Speaker: Hans Vrensen, Barclays Capital
Chairman: Ian Marcus, Credit Suisse

The CMBS issuance for 2005 was €45bn – double that of 2004. More and more borrowers are entering the market seeing it as a flexible financing source. In this session, Hans covers all you ever wanted to know about European Commercial Mortgage Backed Securities, including:

- What they are
- Types of deals
- Investor motivations
- The process and the players
- A market overview

Please book through the website www.ipf.org.uk

Vivienne Wootten, IPF, Acting Executive Director

New research approval process

The IPF wishes to build on its previous research and strongly encourages researchers to submit proposals to extend and develop earlier IPF research projects, which all identify topics suitable for further research. While the IPF is a UK organisation, increasingly IPF members operate on a pan-European and in some cases global scale. IPF research looks to draw on experiences and practices from other property investment markets, to see how they can inform, improve and apply to the UK market.

The IPF appointed a research steering group to take responsibility for all IPF research activities. The IPF Research Director, Charles Follows, reports to the research steering group. The membership of the research steering group is on the website www.ipf.org.uk

There is a three stage approval process:

- Initial discussions with Charles Follows, Research Director at the IPF.
- Submission of a research outline, indicative programme and budget for consideration, in principle, by the IPF research steering group. Ideally no more than two pages.
- Submission of a detailed research proposal (see the separate IPF research submission guidelines in the research section of the IPF website) for formal approval by the IPF research steering group.

The research steering group appoints a project steering group to guide and oversee each research project. The function is to provide technical guidance to the research team undertaking the project and to contribute to the development of the project. A member of the research steering group or a senior member of the IPF chairs the project steering group with the IPF providing administration support.

There are other industry bodies with funds allocated for research. To reduce potential overlap, the IPF liaises regularly with these bodies and works with the Property Industry Alliance. Where there is mutual interest then the IPF aims to undertake and fund joint research projects with such industry bodies. By undertaking research with other organisations, the IPF increases funding, adds intellectual capital, avoids duplication and develops pan-industry co-operation. However, the IPF selects joint research partners with care to maintain the independence, intellectual rigour and quality of the research.

The IPF requires the research teams it contracts to work in a rigorous and independent manner, and will not seek to influence the findings of any research. The results of projects may surprise or challenge conventional wisdom and beliefs in the property investment market. In such circumstances, the IPF seeks to understand and explain the results rather than censor the findings.

The IPF publishes the findings of all research it commissions.

All correspondence and enquires regarding IPF research, should in the first instance, be directed to Charles Follows, Research Director, Investment Property Forum, New Broad Street House, 35 New Broad Street, London EC2M 1NH (cfollows@ipf.org.uk, 020 7194 7925).

Future dates for your diary

Scottish Conference 2006: Is Property Priced for Perfection?

The conference is kindly sponsored by The Royal Bank of Scotland and Miller Developments.

Agenda

Positioning property as an investment product
Francis Salway, Chief Executive, Land Securities PLC
An insider look at the positioning of property as an investment product, its relative attractions to debt and equity investors, and the outlook for REITs in the UK.

Property Investment: where is the money coming from and how can it access the market?
Jenny Buck, Head of Indirect Investment, Schroders
Who are the providers of the recent flows of money into the property sector and what are they looking to achieve from their allocations? How is exposure gained to the property market? What factors determine the types of funds that investors can gain access to? How is a portfolio of funds constructed and what are the issues considered in analysing a fund for investment?

REITs: Where to next?
Ian Marcus, Managing Director, Credit Suisse
The chancellor announced in the 2006 budget the introduction of UK REITs. This was welcomed by the industry as it is felt that UK REITs will make a significant contribution to both the UK property industry and to the country's wider economic success. The question now is: where to next? With legislation coming into force in January 2007 what does this mean to the market? Where are the opportunities and what should one watch out for?

Will the bubble ever burst?
Andrew McLaughlin, Group Chief Economist, The Royal Bank of Scotland
Is the property market over valued? If so, can the economy continue to sustain the over valuation? What are the signs to watch for as the industry undergoes major changes and challenges? This in-depth look at the economy provides a non-industry perspective on the state of property pricing and factors influencing investment decisions.

To book please go to www.ipf.org.uk

14 September 2006: Glasgow (Radisson SAS)

The Paradise Project, Liverpool – The UK's largest city centre mixed-use scheme

12 September 2006: Liverpool (Grosvenor)

Midlands Dinner 2006

19 October 2006: Birmingham (ICC)

IPD/IPF Annual Conference

30 November to 1 December 2006: Brighton (Grand Hotel)

IPF Annual Lunch 2007

31 January 2007: London (Grosvenor House)

Property Derivatives Interest Group (PDIG)

The first edition of the quarterly PDIG e-newsletter was emailed out to all IPF members in March 2006. To avoid email overload, future PDIG newsletters will only be emailed to IPF members who request to receive it. If you want to be included in the distribution list for future PDIG newsletters, please email Suleen Syn, ssyn@ipf.org.uk and put 'PDIG newsletter' in the subject field.

As an IPF member you have free access to the PDIG website which is regularly updated with news and events. Please go to www.propertyderivatives.org.uk for more information.

Events

Midlands Hot Property Party

This fundraising event took place at the Jam House in Birmingham, over £8,000 was raised for charity and split between the Birmingham Children's Hospital, Acorns Children's Hospice and the IPF Educational Trust.

Midlands Region Annual Lunch

More than 200 members and their guests attended this year's Midlands Region Annual Lunch at the Hyatt Regency in Birmingham. Sunday Times journalist, David Smith addressed the audience and many agreed it was one of the best industry lunches held in the region.

Interview with the IPF President: Sir David Clementi

Sir David Clementi, The Prudential Group, and IPF President

Interview by Alex Catalano

In 2005 Sir David Clementi joined the IPF as President. In this interview with Alex Catalano he discusses one of the issues he feels is most pertinent in the business environment today: corporate governance.

"Corporate governance is pretty close to my heart", says Sir David Clementi. In his previous jobs, first as an investment banker and then as Deputy Governor of the Bank of England, he has been intimately involved with the UK corporate scene and concerned about its well-being.

"But as Chairman of the Pru, I'm close to the centre of discussions. We are one of the UK's largest companies and we also invest significant amounts on behalf of our policyholders in other companies, so corporate governance is a central aspect of the job."

"In mature economies, I believe that good, proper governance does lead to good decision taking; indeed, that proper governance is fundamental to investor confidence, which is clearly central to how markets operate and to the proper allocation of capital", he comments.

Sir David's own background is mainly in the quoted sector and he says his views apply primarily there. "Although it seems to me that unquoted companies should think pretty hard about which standards they want to adopt", he adds.

There are three issues which Sir David considers particularly important: the chairman's role, the role of non-executive directors, and how companies apply the Combined Code on Corporate Governance.

"First, the chairman is responsible for proper process and decision-making in the board of directors. Second, he is responsible for ensuring the board sets out to shareholders a clear strategy about how it intends to build shareholder value. Third, the board has a responsibility for ensuring that the management team is strong and cohesive, particularly the most senior parts of it, who are responsible for carrying out the strategy. The board must recognise that it has accountability to shareholders – not just on the basis of an annual meeting and report, but on a more frequent basis."

As Sir David sees it, the chairman should ensure that there is "significant transparency" in the way these things are done. "Some information about how they are done, the process, how strategy is reached, seems to me appropriate."

Though there has been considerable debate in the UK on whether a chairman should be executive or non-executive, Sir David does not think these terms are particularly helpful. "There are certain jobs the chairman has to do. In large, international companies, in complex businesses, they might take up four to five days a week. In some rather straightforward single-product businesses, they might be done in a day a week. The question to ask is, "in the context of the company, how many days are you chairman?", he notes.

In his own case, Sir David spends quite a bit of time on the Pru. "There are some weeks when I'm working seven days a week, on others it might be two or three", he says. Just now, he has been pretty busy preparing for the Pru's annual general meeting.

In Sir David's view, it is important to have a separate chairman and chief executive. "The chief executive's role is to carry out the strategic direction set by the board. One of the jobs of the chairman and non-executive directors is to judge the performance of the chief executive. How is that to be done if they are one and the same person?"

In the UK, this and other guidelines for companies and institutional shareholders are enshrined in the non-statutory Combined Code on Corporate Governance. However, Sir David strongly believes that while the code sets out general good practice, what is best practice may differ from company to company.

The code's guidelines, Sir David stresses, are bounded by the principle of "comply or explain". That is, companies may deviate from what the code recommends, but in that case they need to give shareholders legitimate reasons for doing so.

"For example, the code's view is that, as good general practice, a chief executive should not move up to be chairman. My view is that there may be some circumstances where it is appropriate for the CEO to move up. But the board needs to think about it carefully, explain why and take their shareholders with them."

The code also recommends that independent non-executive directors should make up a majority on the board. Here, Sir David concurs. "Non-executive directors are appointed by shareholders and should be accountable to them. The key role of non-executive directors is to understand the key drivers of the business, and based on that information, to be able to challenge the executives, but also to give support", he says.

"That's what good boards are seeking. It's not just a question of saying, 'that's the right thing to do', but a deep appreciation of what the risks and rewards are."

To create value for shareholders, Sir David believes the planning process is important. "My view is that boards are best advised to distinguish between longer-term strategic discussions and the annual budgeting process. It's so easy to get caught up in the day-to-day business and never find the time in board meetings to get away from day-to-day operational problems and think about the direction you are going – the geographies, the product areas you do or do not want to be in."

Sir David himself is a non-executive director of Rio Tinto, the mining company. "I do it because it's a very interesting worldwide company, a very good company. I get a view of how another major international organisation operates, so it gives me a reference point for my own business", he says.

With the increasing emphasis on and complexity of corporate governance, companies are having to devote more resources and time to this aspect of business: the code's recommendations include audit committees, remuneration committees, nomination committees and independent non-executive directors.

Sir David doesn't think the burden is excessive. "I'm pretty content. It is entirely open to some companies – this might be true of smaller entrepreneurial ones – to say, we note it, but we think this is a better route for us to go. They can argue they're not going to comply with something in the Code because the disadvantage heavily outweighs any possible advantage. They're entitled to do so, provided they explain credibly why they've done it, and it's not just an easy way out."

"There's nothing morally superior about good governance", declares Sir David. "Good governance is in place to help good value creation. That's the issue."

The Chairman of Prudential since 2002, Sir David took up the role of President of the IPF last August. His decision to get involved was partly personal, partly professional.

"Professionally, the Pru is a very, very large investor in the property sector. The health of the property sector is important to us", he says.

"Personally, I've always been interested in the property sector. When I was an investment banker, one of my larger clients was Hammerson. It was during both Sydney Mason's and Ron Spinney's tenures as chief executives. The first deal I did for Sydney Mason was the acquisition of Reunion Properties, in about 1979."

Sir David also worked closely with Ron Spinney. "David's a great guy, very enjoyable company, doesn't take himself too seriously – not a streak of pomposity or arrogance," says Spinney. "He has a first-class mind – an intellectual ability to grasp the significant things about an investment transaction and property as an investment vehicle. That is very important."

Spinney first met Sir David after joining Hammerson as Chief Executive in 1993.

"The company required a rights issue to sort out the balance sheet. David led it, working in conjunction with BZW," says Spinney.

"But more importantly for me, he gave me very good advice and was a very good sounding board in my first one or two years in sorting out a suitable business plan for Hammerson, which needed a considerable amount of reorganisation. I benefited very much from that, and I like to think the company did as well."

A chartered accountant with an MBA from Harvard University, Sir David worked at the investment bank Kleinwort Benson for 22 years, including stints as its Chief Executive and Vice Chairman. He has wide experience and extensive links with not just business, but also the professions and government. He was Deputy Governor of the Bank of England for five years, and also headed the government's review of the regulatory framework for legal services in England and Wales.

"I was asked, largely on the grounds that I wasn't myself a lawyer, but I did know quite a lot about regulatory systems – accountants, banks and insurance companies. I really enjoyed doing it," says Sir David.

IPD / IPF Property Investment Conference 2006

30 November - 1 December, The Grand Hotel, Brighton

The IPD / IPF Property Investment Conference is the **flagship** event in the UK property investment industry for all who value first-rate research, open debate and convivial company.

Heading into its 16th year, the event has an exceptional line-up of industry figures coming together to provide networking opportunities of the highest quality.

The leading property industry event in the UK

The **premier event** in the UK real estate calendar - with essential analysis, inspiring speakers, lively discussion and fantastic networking opportunities, the conference will be held once again at The Grand Hotel in Brighton. This two-day event attracts over **450 property professionals**.

Risk - opportunities it offers and threats it poses

UK property investors have been enjoying strong returns for the last few years, and are relatively sophisticated in understanding the market in which they operate. But, how can they control for external market uncertainty and risk factors beyond their control?

Property and uncertainty

The conference focuses on several types of risk - economic risk, catastrophic financial event risk, capital market risk, portfolio risk, environmental risk, valuation risk, investor behaviour risk… and concludes with risk and return tradeoffs.

“This conference has built a reputation for being one of the most enlightening events of the year, whilst providing excellent networking potential.”

Bill Hughes, Chief Executive Officer, RREEF

For more information, or to register, contact:

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“The IPD/IPF Conference is consistently the most thought provoking event in the industry calendar.”
Paul McNamara, Director of Property Research, Prudential Property Investment Managers

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