



Investment
Property Forum

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Looking ahead: a new IPF Vision and Research Programme

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In this issue:

- 1 Message from the Chairman*
- 2 The IPF launches its new Vision*
- 4 IPF Research Programme – the next phase*
- 6 Solvency II: Informing a new regulatory framework for real estate*
- 8 The UK commercial property lending market*
- 16 Property cycles and gearing levels*
- 19 Where next for Irish property?*
- 22 Property by nature, property by investor – Report on the IPF Conference in Scotland*
- 24 Institutional residential investment – opportunities and challenges*
- 27 Don't wake up – the property owners' nightmare might be coming true!*
- 28 The Green Deal – to Band E and beyond!*
- 29 UK Consensus Forecasts, May 2011*
- 33 European Consensus Forecasts, May 2011*
- 35 IPF Survey of IFAs, June 2011*
- 37 Forum activities and announcements*

From the editor



Sue Forster, Executive Director, IPF

This edition of Investment Property Focus, the IPF's new Chairman, **Phil Clark of Aegon Asset Management**, discusses his priorities for 2011-12. To a large extent, these are driven by the IPF's new three-year Vision statement, an outline of which is provided by **Neil Turner of Schroder Property Investment Management** and chairman of the IPF Vision Group.

The new IPF Vision highlights the growing importance of the residential institutional investment market. **Cathryn Vanderspar of Berwin Leighton Paisner** outlines the opportunities and challenges of the sector, given the positive announcements in the Budget 2011.

The overview of the eighth annual IPF conference in Scotland, which took place last month in Glasgow, includes the views of the speakers, **Paul Findlay of SWIP**, **Phil Clark of Aegon Asset Management**, **James McGann of RBS**, **Bill Hughes of Legal & General Property** and **Nick Berry of Mountgrange Investment Management** on the outlook for the UK economy and the property market.

One significant piece of regulation likely to have profound effects on allocations to property is that of Solvency II. As **Ian Cullen of IPD** explains, the Solvency II documentation proposes a 25% solvency capital requirement for directly-held property investments of insurance companies. IPD's research, sponsored by seven European trade associations, including the IPF, suggests that this is too high.

A prerequisite of the Vision was the successful re-financing of the IPF Research Programme for 2011-15. We have now launched the new £1.1m Programme with 22 sponsors, 14 of which are previous sponsors. **Pam Craddock**, the **IPF Research Director**, outlines the plans for next four years, which are likely to keep the Research Steering Group very busy.

The level of outstanding debt on commercial property continues to be of great concern, despite the fall of 9.4% in the total amount, as identified in the thirteenth research report on lending patterns of the major commercial property lenders operating within the UK published by De Montfort University in May 2011. However, according to **Bill Maxted** and **Trudi Porter of De Montfort University**, the apparent decline in the debt level is due, at least in part, to the large scale transfer of loans from lending organisations to government and other agencies, such as the National Asset Management Agency (NAMA) in Ireland, so that they no longer show up in the research data. **Shirley Smith**, recently returned to the UK after a spell working for NAMA, looks at the recent Irish financial history and its impact on the property market.

Richard Barkham and **Cynthia Parpa of Grosvenor Group Research** consider whether it is possible to use a single indicator to help set gearing levels in property portfolios and make them more systematic, hence minimising risk, enhancing returns and maximising NAV growth.

Two members of the IPF Sustainability Interest Group have written articles highlighting current Government policy that could have a marked impact on our market. **Bill Gloyn of Jardine Lloyd Thompson** thinks that the proposals regarding the funding of flood prevention works will increase the level of uncertainty in future investment and portfolio management decisions. **Chris Brigstocke of Squire Sanders Hammonds** explains the implications of the 'Green Deal' proposals, the method by which home energy efficiency improvements would be paid for by savings from energy bills. There was a further promise 'to take measures to improve energy efficiency in business and public sector building'.

Summaries of the IPF UK and European consensus forecasts in May and the survey of IFAs in June are also included in this edition.

The next Focus will be published in early December. If there are any topics you think we should cover, please contact me.

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Message from the Chairman

Some of you will have heard me suggest at the IPF Annual Dinner that most of us might share a slight sense of schizophrenia about the UK property investment market at present. We've seen positive IPD All Property returns in 2010 – and yet values are still falling on some secondary properties; bank related assets have started coming to the market at more realistic prices – but debt seems difficult to secure for all the but the best properties; some aspects of the market feel more active – and yet we have a wave of regulation causing investment decisions to be deferred.

I suspect most of us probably expect such dichotomies to prevail for a few years yet as the UK economy rebalances its books and the property industry completes a significant task of deleveraging.

These are challenging times indeed and I feel both honoured to be invited to become Chairman of the IPF and excited at the richness of the IPF's current programme of activities during my year in office. At the heart of so many of the key activities has been our retiring Chairman, John Gellatly. On behalf of us all, I would like to thank John for his energy and commitment, not just as Chairman, for his many years of engagement on a range of topics such as REITs, property debt and research. He had three priorities for his year in office:

- To ensure the re-financing of our Research Programme;
- To foster and extend our relationships with government and other authorities; and
- To focus on increasing and extending our membership.

Research

The overriding achievement of this year has been the re-financing of the Research Programme for 2011-15, despite the still-difficult economic climate.

I am delighted to report that we are now launching the new Programme with 22 sponsors, 14 of whom are previous sponsors.

Many thanks must go to the sponsors themselves for agreeing to support the Programme over the next four years.

Fostering relationships with government and regulators

Over the last 12 months, we have also engaged with government and other regulatory authorities on a number of issues including:

- Accounting for leases;
- Solvency II;
- The Directive on Alternative Investment Fund Managers;
- Global Investment Performance Standards (GIPS);
- Institutional investment in the residential sector;
- Professional competence and ethics; and the
- OTC Derivatives Regulation (EMIR).

Perhaps of most note are the presentations that were made to the Bank of England Property Forum on senior debt and the

outlook for the UK CMBS market, around which so many of our challenges remain dependant.

Membership

Overall numbers have increased slightly, even in this challenging market.

The desire to increase the proportion of younger members has led to the establishment of the IPF: Next Generation Committee, which is tasked with organising events and services targeted at professionals in our industry with 5-10 years' post-graduate experience.

The extension of our membership within the financial markets is also underway following the formation of the Property Banking Forum, a joint group with the Association of Property Bankers.

So what are MY priorities for the year ahead?

To a large extent, these are driven by the IPF's new three-year Vision statement, which has just been approved by the Management Board, and my thanks in particular go to Neil Turner who led the Vision Group in creating the new Vision statement.

It will come as no surprise that the two top priorities identified are:

Firstly, How Property Is Funded & Financed, including a core focus on bank debt, equity capital flows, the need to engage more fully with the banking sector and a greater understanding of the role of property derivatives;

And secondly, Regulation & Legislation, with the requirement for the IPF to be far more proactive in both identifying the potential impact on the market of regulatory issues and engaging with the appropriate organisations at an early stage.

To achieve all these goals requires the continued engagement of you, the Membership, both formally through committees and special interest groups and informally by engaging in discussion and debate at seminars and/or supporting our various social events.

The property industry has a long track record of adaptability and innovation which will see us through what could be a few more tough years to come.

In my view, the key to successfully adapting to the current challenges of limited debt, slow economic growth and scarcity of capital will be to ensure we are open and honest about the implications of these challenges for our industry – whether they be positive or negative.

The IPF will remain focused on supporting the industry through these challenges and opportunities through its new Research Programme, its Vision and the many events it organises throughout the UK. I invite you to engage with the IPF across all these activities to get the most from being a member.

Best wishes
Phil Clark



Phil Clark,
Head of
Property,
Aegon Asset
Management

The IPF launches its new Vision

Every few years, the IPF undertakes to review the Vision that it has for the organisation. The periodic review is necessary as the challenges facing the property investment industry are constantly changing and the years since the Vision was last updated in 2006 have certainly been no exception. Indeed arguably, those years provided some of the most dramatic change in the modern history of property investing.

How the industry addresses the changes that have occurred in the recent past will dictate the success we enjoy in the near future. The Management Board is very keen to make sure the IPF is well placed to address with the challenges we now face.

Putting the Vision together

The Vision Group was assembled at the invitation of the immediate past Chairman of the IPF, John Gellatly. The members of the Group were:

Neil Turner, Schroder Property Investment Management (Chair)
David Adler, Langham Hall
Phil Clark, Aegon Asset Management
Toby Courtauld, Great Portland Estates
Louise Ellison, Quintain Estates and Development
Sue Forster, IPF
Amanda Howard, Nabarro
Guy Morrell, HSBC Global Asset Management
Will Robson, PRUPIM
Max Sinclair, Eurohypo
Andrew Smith, Aberdeen Asset Management
Michael Stancombe, Hogan Lovells

We sought views as to the important issues for the industry in the next few years from:

- the membership;
- the Special Interest Groups;
- regional boards;
- former IPF chairmen;
- IPF life members; and
- our President – Sir David Clementi.

All of these contributions were incredibly valuable and the Vision Group is grateful to all the participants. During this process there was a great deal of discussion and debate within the Group in order to ensure that we focused on the really big issues.

What does it say?

First off, the IPF's Mission statement has changed and now reads:

The IPF's mission is to enhance the understanding and efficiency of property as an investment, including public, private, debt, equity and synthetic exposure, for its members

and other interested parties, including government, by:

- undertaking research and special projects and ensuring effective communication of this work;
- providing education; and
- providing a forum for fellowship, discussion and debate amongst our members and the wider investment community.

The changes reflect the move away from a primary focus on direct property and the need to communicate better and more extensively what we are doing. The Vision Group also wanted to emphasise the very important role that the IPF plays in providing opportunities for the industry to network.

In terms of priorities, there were two 'top' and three 'high' priorities identified. These are as follows:

Top priorities

To enhance the understanding of:

1. how property is financed and funded;
2. the impact of legislation and regulation.

High priorities

3. sustainability;
4. internationalisation of real estate;
5. residential property investment;

1. To enhance the understanding of how property is financed and funded

In the past few years there has been a fundamental change in the way capital has been provided to, and procured by, the property investment sector. Traditional capital structures are being transformed by the proliferation of new equity, debt and synthetic exposures. We believe these changes will continue, with different forms and levels of equity and debt being used by various players. These capital structures will react differently to the economic, business and property cycle. There is therefore a requirement for our members, the industry and other interested bodies to understand how the financing and funding of property will impact the performance of property as an asset class. The requirement to understand the role of property derivatives within this process remains essential.

Policy aim

We believe that the Forum, particularly through the CPD Group, Educational Strategy Group, Research Programme, Property Banking Forum and Property Derivatives Interest Group has a very important role to play here in respect of 'financial education'.



Neil Turner,
Schroder
Property
Investment
Management,
and Chair of
the IPF Vision
Group

2. To enhance the understanding of the impact of legislation and regulation

The volume of regulatory and legislative changes that impact the property industry has increased dramatically over the last few years. This is set to continue with further activity not just in Westminster but also in the EU and globally.

Policy aim

The IPF should be thought leaders and providers of research-led analysis on areas that could significantly impact the real estate investment sector to ensure there is well-informed debate. The IPF should be proactive in identifying any proposed relevant legislative and regulatory changes and inform its membership as to the likely impact of these.

3. Sustainability

Over the next three to five years, the sustainability agenda is expected to centre on policies to reduce carbon emissions as part of a broader strategy to combat climate change. The built environment presents significant opportunities to achieve substantial carbon emission reductions and, as such, is expected to continue to be a target for regulation and legislation. This has important implications for property investment. The IPF Sustainability Interest Group has been effective in bringing this issue to the attention of the membership and in raising the general awareness of specific, pertinent issues. As the agenda has moved forward, we now need to focus on engaging with policy makers and others to ensure the part property investors can play in achieving policy goals in this area is properly understood.

Policy aim

To provide the investment community with a voice with which to engage with policy makers and other industry sectors on the subject of sustainability. To support the development of regulation and legislation that is cognisant of the property investment process and its function within the economy. To provide education and research that informs the membership and enables it to engage positively with this issue.

4. Internationalisation of real estate

Another area where the property investment market has changed substantially in the past few years has been on the international front. We continue to see increases in global capital flows for real estate – characterised by UK investors looking to place capital into non-UK assets and non-UK investors allocating to UK real estate. We are also, as outlined above, witnessing ever more European and international legislation and regulation affecting these allocations.

Policy aim

The IPF should remain a UK-focused organisation. However, through education, training and research, the Forum should become a ‘passport for international investment’. This will be aimed at providing UK-based investors with an appreciation of other international investment property markets and the non-UK investors with an understanding of the UK investment market in an international context.

5. Residential property investment

Residential property is an asset class that is several times larger than the commercial sector and the recorded investment performance has also been acceptable. However, UK property fund managers are amongst the least likely to invest in either their domestic or any other residential sector.

The Vision Group believes that at least part of the reason for this situation is the lack of training, education and experience of the sector.

Policy aim

To ensure high-quality research and education material is available to the investment community with regard to the residential property asset class in the UK.

Next steps

This Vision will be executed through the formal IPF business plan, due for approval by the Management Board in the autumn. The Vision will be reviewed every three years, unless market circumstances dictate that the review should occur sooner.

IPF Research Programme – the next phase

We are delighted to announce the successful refinancing of the IPF Research Programme for 2011 to 2015. External funding of £1.1m has been secured from 22 donors, 14 of whom were sponsors of the previous Programme. The sponsor organisations are shown on the next page.

The Programme, which underpins much of the IPF's activities, originated as a joint initiative with the IPF Educational Trust in 2003. The second phase from 2006-09, supported by 24 sponsors, produced a significant number of reports, including major works on such topics as risk, sustainability and pricing. In addition, we introduced the Short Paper Series in order to:

- provide robust information in a short format on specific issues;
- generate and inform debate among the IPF membership, the wider property industry and related sectors; and
- publish on topical issues in a shorter time-scale than for more detailed research projects.

The funds remaining from the 2006-09 Programme, extended until April 2011 through additional payments by the sponsors and a one-off donation from the Educational Trust, have been committed or allocated to projects that will deliver results in the course of this year. These include two major reports on depreciation and understanding the asymmetrical behaviour of correlations in real estate investments.

Plans for the new Programme

The agenda for the next Research Programme has been designed to address the major investment themes of asset allocation, stock selection and asset management.

In addition to our major reports and the Short Papers Programme, our regular survey publications are an important output of the programme and perennially popular output of the programme. These now include:

- UK Consensus Forecasts;
- European Consensus Forecasts;
- Survey of IFAs; and
- Quarterly Commercial Property Confidence Survey (jointly with Lloyds Banking Group).

These four surveys produce 13 publications each year. We will continue to publish these and add further surveys as opportunities arise.

In developing the research themes, we will continue to draw on the expertise of our Research Steering Group (RSG), the research sponsors and other parties, including the members of the IPF Special Interest Groups on indirect commercial property investment, real estate debt, international property markets, sustainability, residential property investment and property

derivatives. This structure enables the Programme to leverage expertise from a wide range of specialists across the industry.

Research Steering Group (RSG)

The RSG plays a fundamental role in the research process by ensuring the research we commission is of the highest quality and is relevant and useful to both the IPF membership and wider investment community. Its terms of reference comprise responsibility for all research projects and activities including, among other things:

- Considering research proposals submitted to the IPF for funding;
- Identifying suitable topics for IPF research;
- Preparing and issuing briefs for research projects;
- Appointing research teams and contractors to undertake research;
- Appointing project steering group for individual projects, to supervise the appointed research teams;
- Overseeing the preparation and publication of regular publications.

Membership of the RSG, as shown below, is a balance of researchers, practitioners and academics. The IPF Research Director and Executive Director are permanent members. The RSG reports to the Management Board and the chairman of the Group becomes automatically a member of the Board.

Members of the Research Steering Group

Andrew Smith, Aberdeen (Chairman)	Rob Martin, Legal & General Property
Asli Ball, GIC	Alan Patterson, AXA Real Estate
Richard Barkham, Grosvenor	Ben Sanderson, Hermes Real Estate
Gerry Blundell	Alistair Seaton, LaSalle
Alessandro Bronda, Aberdeen	Ed Trevillion, SWIP
Mark Callender, Schroders	Sue Forster, IPF
Peter Clarke, Recept	Pam Craddock, IPF
Malcolm Frodsham, IPD	
Claire Higgins, BNP Paribas	
Colin Lizieri, University of Cambridge	



Pam Craddock,
Research
Director,
IPF

Should you have any questions about the IPF Research Programme or suggestions for research topics please contact:

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IPF Research Programme Sponsors 2011-15



Solvency II: Informing a new regulatory framework for real estate

IPD was commissioned by seven leading European trade bodies, including the IPF, to undertake a detailed review of the Solvency II regulatory framework proposed for determining insurance company capital adequacy rules from 2013. The study focused specifically upon real estate.

The European Insurance and Occupational Pensions Authority (EIOPA) Solvency II documents advocate risk-based regulation and include a proposal – to apply a 25% solvency capital requirement (SCR) for directly held real estate investments – which could have profound effects upon the real estate allocations amongst insurance companies across Europe. They remain one of the sector's most important investor groups, accounting for between 25% and 35% of total European property investment market cover.

The 25% threshold test was a direct response to a collective financial sector failure to effectively hedge the implicit market risks of the asset classes in which they were invested prior to 2007. It was established by:

1. Identifying the most volatile major European property investment market over the last 25 years – the UK;
2. Finding the greatest single 12-month loss suffered over that period – the 'one in 200 year event' or the 0.5% value at risk – close to 25%; and
3. Setting an SCR sufficient to meet that outturn if such an event should ever recur.

Review of the regulatory framework

The research started with an intensive scrutiny of the internal logic and supporting analysis of the EIOPA proposals. This review showed that EIOPA has brought a meticulous and novel risk perspective to bear upon a more prudent approach to capital adequacy. This was built upon a broadly robust technical base, but one which made some questionable assumptions.

The high asset class correlations quoted could not be replicated, and their role in the bottom line proposals was unclear, though recognition of the importance of diversification was welcome.

Probably the most crucial decision, however, was to adopt the longest and most frequent property return history available (the IPD UK Monthly Index) as the volatility baseline for all European portfolios, no matter what their mix of market exposures. This appeared as an intermediate position which could be refined without sacrificing or even diluting the prudential aims of Solvency II.

Survey of initial insurance industry responses

Our survey of 18 major European insurance businesses, which demonstrated a widely shared commitment to property, both as a risk diversifier across asset classes, sectors and territories, and as a key source of secure income delivery, underlined this doubt about the selection of a single market as the SCR baseline for

the whole of Europe. It also revealed a consensus demand for a broader and better information and analysis base.

Improving the information base for Solvency II modelling

To meet this demand and better inform the new regulations, the project team created 10-year quarterly indices for all main European property markets, enabling more effective correlation and cluster analyses. These showed how, in the deepest and most closely synchronised of global economic upheavals, this group of 12 markets tracked three clearly distinct patterns of property investment response.

Adjusting the quarterly valuation-based indices one step further, to allow for the transaction driven volatility intrinsic to illiquid real estate markets, revealed clear patterns of extra volatility, and thus tail values at risk above valuation determined levels. But again these varied markedly by country and by region, as shown in Figure 1, from less than 10% within the eurozone to over 23% in the UK (where trading-linked extreme volatility did not exceed that of the valuation-based series).

IPD's recommendation on the basis of this work is therefore to add force to the principles that underpin Solvency II by refining the detail of the regulation in a way which is sensitive to the documented and complex diversity of property investment practice and performance across Europe. If, for the sake of simplicity however, the broadest available pan-European property shock factor was requested of IPD, to be based on the best evidence of tail values at risk currently available, this would be no higher than 15%, but preferably allowing modest company model flexibility around this figure.



Ian Cullen,
Director and
Co-founder,
IPD

The report, 'The IPD Solvency II Review: Informing a new regulatory framework for real estate' was prepared by Ian Cullen, Malcolm Frodsham, Mark Clacy-Jones and Kate Gimblett of IPD, with specialist inputs from Professor Tony Key of the Cass Business School and Dr Stephen Devaney of the University of Aberdeen.

The research project was commissioned by seven leading European trade bodies, led by INREV, the European Association for Investors in Non-listed Real Estate Vehicles, and supported by six other key associations from European real estate and insurance industries:

The Association of British Insurers (ABI)

The British Property Federation (BPF)

Bundesverband Investment und Assetmanagement (BVI)

The European Public Real Estate Association (EPRA)

The Investment Property Forum (IPF)

The German Property Federation (ZIA)

Figure 1: Headline 0.5% tail values at risk from Dec 2002

Rolling 12-month returns	Valuation-based Index		Transaction-linked Index	
	Standard deviation	0.5% VAR	Standard deviation	0.5% VAR
To December 2009				
Eurozone only				
France	6.9	-2.3	9.7	-8.9
Netherlands	4.1	-2.5	7.7	-8.1
All eurozone	3.1	-0.1	7.8	-10.4
To December 2010				
UK only				
All Assets	14.2	-23.3	14.3	-23.2
To December 2009				
Pan-European				
UK + eurozone	5.8	-7.1	9.0	-13.3

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The UK commercial property lending market

De Montfort University published its thirteenth research report on lending patterns of the major commercial property lenders operating within the UK in May 2011. The analysis, covering the year up to 31 December 2010, was based on the responses from 57 organisations (66 lending teams), representing a 100% response rate of those asked to complete this year's questionnaire. The rate and detail of responses to individual questions varies between organisations due to reasons of confidentiality and availability of data. Thus, 100% response rate may refer to a different total from one question to another.

Throughout this research, 'commercial property lending' is taken to mean all lending secured on UK commercial property including residential investment and development but excluding owner occupier residential mortgages. Where reference is made to the commercial property loan books of lending organisations, this is taken as the net exposure to UK commercial property excluding equity finance (i.e. net of any loan amounts sold down to other lenders and net of any securitised loans unless otherwise stated).

In order to show the variety of lending patterns and the differences between lending organisations a categorisation of lenders has been devised which is applied throughout the analysis. With effect from this report, data from building societies and UK lenders have been combined. This is to guard against identification of individual active building societies within the shrinking numbers within this category. For the purposes of this report, the nationality of lenders is determined by the location of their head office.

Value of outstanding loan books

A total value of £225.5bn of outstanding debt, including mezzanine finance and loans of approximately £18.7bn secured by social housing was recorded by the survey as at 31 December 2010. A further £25.9bn of loans were committed but not drawn at this date. The comparable total figure for 31 December 2009

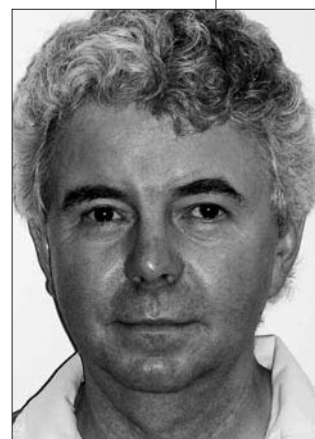
was £247.7bn so the total value of outstanding debt declined 8.9% during the year. Figure 1 shows a breakdown of the total debt in 2010 by category of lender and type of finance.

The debt secured by commercial property only, excluding undrawn amounts and loans to social housing, totals £206.9bn, compared to £228.3bn in 2009, a decrease of 9.4% – see Figure 2. This is the first decline recorded by the research and is the result of a number of factors. The large-scale transfer of loans from lending organisations to government and other agencies will have resulted in these loans no longer being recorded in the research data. Also, the general activity of lending organisations to reduce outstanding debt by a combination of the disposal of assets (including both performing and non-performing assets), consensual restructurings including equity injections, accelerated amortisation schedules (including full cash sweeps) and repayments in the course of normal business, have all helped to reduce the total value.

The allocation by lender category of the £206.9bn is shown in Figure 3.

On the assumption that the research captures between 90% and 95% of the specialist commercial property lending market, it is estimated that the market size is in the region of £218bn to £230bn without social housing at year-end 2010.

However, this estimate does not include the value of undrawn funding of £25.9bn (which has declined substantially from £42.5bn at year-end 2009), the value of loans sold into the CMBS market, or the value of loans acquired by the National Asset Management Agency (NAMA).



Bill Maxted,
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of Corporate
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De Montfort
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Trudi Porter,
Department
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De Montfort
University

Figure 1: Category of lender and type of finance

Category of lender	Reported UK outstanding loans including social housing	Mezzanine	Equity	Reported UK outstanding loans including social housing, mezzanine and equity	Reported amount of committed funds not yet drawn
	£m	£m	£m	£m	£m
UK Lenders and Building Societies	150,350	522	299	151,171	22,587
German Lenders	24,150	11	7	24,168	2,011
Other International Lenders	46,803	14	98	46,915	1,223
North American Lenders	3,678	3	0	3,681	125
All Lenders	224,981	550	404	225,935	25,945

Figure 2: Outstanding debt secured on commercial property only

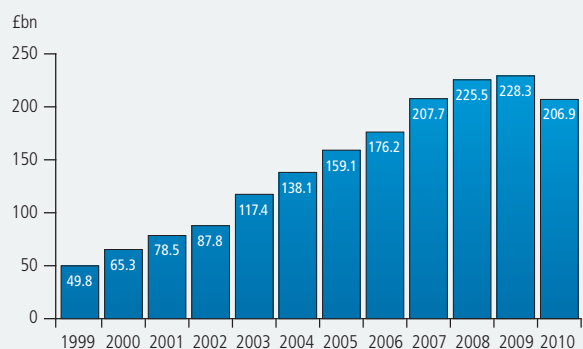
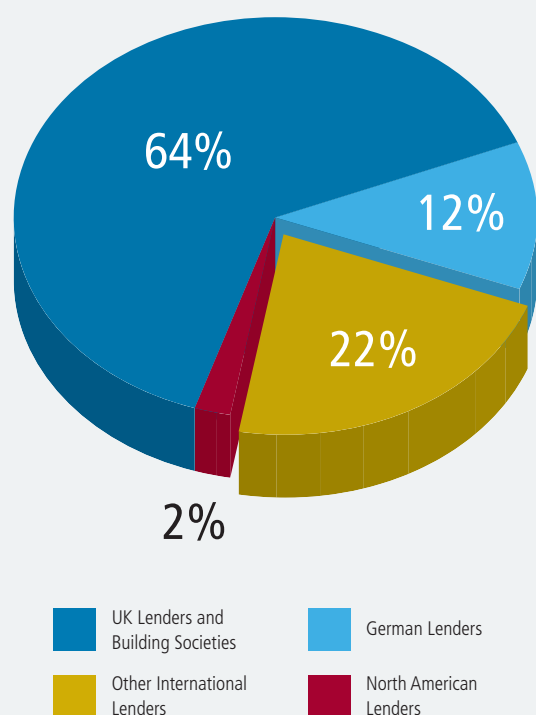


Figure 3: Allocation of drawn funding secured by commercial property



Fitch Ratings have provided data for the value of outstanding CMBS issuances that they have rated and that included loans secured by UK commercial property. At year-end 2010 this amounted to £33.99bn. Additionally Fitch Ratings estimate that the total outstanding balance of UK CMBS was approximately £47bn at year-end 2010 (£50bn in 2009).

NAMA is an asset management company that is acquiring good (performing) and bad (non-performing) loans secured by all forms of real property from five financial institutions whose head

offices are located in Ireland. NAMA is a state-owned loan workout vehicle. It will manage the loans that it holds with the intention of obtaining the best possible return for the taxpayers of Ireland over an estimated timeframe of seven to 10 years. By year-end 2010, NAMA reported that loan balances, valued at par, of €71bn¹ (approximately £61bn) had been acquired by the agency. Of this amount, approximately 35%² (£21bn) related to loans secured by property located in the UK. The value of £21bn represents an additional amount of outstanding debt secured by UK commercial property that will not have been reported to this research at year-end 2010.

Therefore at year-end 2010, it is estimated that the total value of outstanding debt including balance sheet lending, outstanding balances in the CMBS market and the value of par debt held by NAMA was in the range of £286bn to £298bn.

Loan originations completed in 2010

In view of the changing market conditions and the ongoing impact of the financial crisis since year-end 2009, the research questionnaires have asked for details of both new lending and extensions to loans that should have matured during the respective reporting period. Extensions to maturing loans can be recorded as new lending, refinancing or not lending in the strictest sense. Figure 4 shows the amount of new senior and junior debt loan originations, mezzanine finance and loan extensions completed during 2010 and secured by commercial property and social housing. The value of loan originations secured only by commercial property was £19.92bn. In addition another £10.92bn of extensions to maturing loans was reported.

UK Lenders and Building Societies recorded 52% of the total loans when identifiable extensions to loans and social housing are excluded. In contrast, North American Lenders only extended loans during 2010 and did not undertake any new business.

With regard to the £19.9bn of loan originations, approximately 66% was undertaken by just six organisations. This group comprised four UK Lenders and Building Societies and one organisation each from the categories of German and Other International Lenders. Approximately 82% of originations were completed by 12 organisations. This proportion is the highest ever recorded by this research.

Importance of commercial property lending

At the end of 2010, organisations that held 71% of the outstanding debt of £225.5bn, estimated that this lending represented 15% of their total lending in the UK. Figure 5 below shows the corresponding proportions reported at previous year-ends since this data was first collected in 2004.

Overall, only 31% of organisations increased the value of their outstanding loan books during 2010. This compares with 49%, 60% and 76% of organisations during 2009, 2008 and 2007 respectively and between 54% and 68% recorded annually between 2000 and 2008. German Lenders are significant as

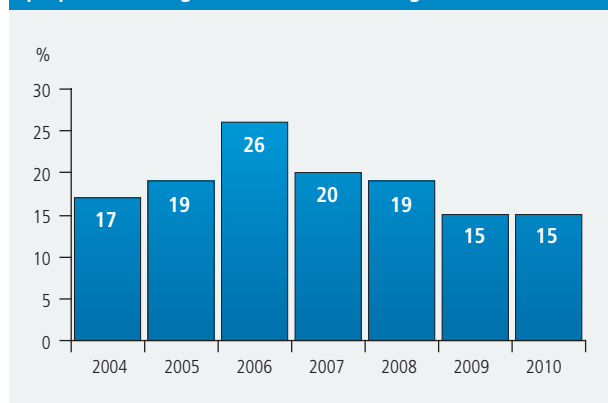
¹ Emmet. G., (2011) An Introduction to NAMA Conference paper 5 May 2011

² Ibid

Figure 4: Value and allocation of loan originations in 2010

Category of lender	Value of lending (senior & junior debt) excluding extensions to maturing loans £m	Mezzanine originated £m	Value of extensions to loans that should have matured during 2010 £m	Total £m
UK Lenders and Building Societies	11,244	36	4,960	16,239
German Lenders	5,327	–	1,826	7,153
Other International Lenders	4,180	29	4,077	8,285
North American Lenders	–	–	56	56
All Lenders	20,751	65	10,919	31,733

Figure 5: Proportion of commercial property lending as a proportion of organisations' total lending



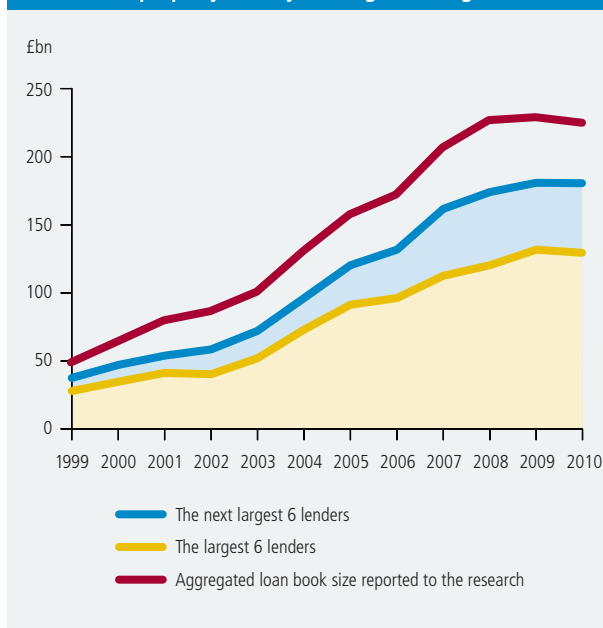
having the largest proportion of organisations increasing loan book size. Of all the organisations that increased their loan book during 2010, 61% were German Lenders.

The value of outstanding debt continues to be concentrated in the loan books of a relatively small number of large organisations. Figure 6 shows the amount of outstanding debt held by the largest six and then the next largest six lenders. Since 1999, the largest six organisations, by book size, have held over 50% of the total outstanding debt retained within loan books. Combined together with the six next largest organisations, the largest 12 lenders have, since 2002, held approximately three-quarters of outstanding debt.

CMBS

Relatively few CMBS transactions were completed during 2008 and 2009 and no issuances were reported to the research during 2010. Investor appetite for these securities evaporated after the financial crisis in 2007.

Figure 6: Amount of outstanding debt secured by commercial property held by the largest 12 organisations



Syndications

During 2010, £737m of debt was reported as being syndicated by eight organisations, six of these were German Lenders, representing 14% of contributing organisations. This is lower than that of 20% who reported syndications at year-end 2009 and the 32% of organisations who reported syndications at year-end 2008.

Other transfers off lenders' balance sheets

In addition to securitisations and syndications, the questionnaire requested organisations to report on the outstanding volumes of debt, if any, that had been sold. In total, 11 organisations reported that they had sold debt during 2010. Three of these organisations reported that debt had been transferred to

NAMA at the perceived market value of the commercial properties acting as security. From information available from NAMA³, average discounts to the par value of the total value of loans (€71bn) transferred was 58%. Four organisations reported selling debt to other lending organisations – the aggregated amount is estimated to be a little under £200m. Discounts on disposals ranged from ‘none’ to 50%. A further four organisations reported transferring, or selling, debt to ‘other’ third parties. The recipients and purchasers of these included borrowers, work out funds and overseas publically owned wind-out funds. These aggregated disposals amounted to approximately £185m and discounts ranged from ‘none’/‘small’ to 10%.

Twenty organisations reported taking possession and selling the commercial property securing the loans. The total value of property sold and reported to this research was £506m. Eleven organisations (19% of the sample) reported that they had taken equity positions in distressed lending positions. It is understood that once this position has been taken, the commercial property securing the loans will be sold off at an opportune time. During 2010, £1.1bn of such positions were reported as having been taken and at the year-end approximately £0.16bn remained in place.

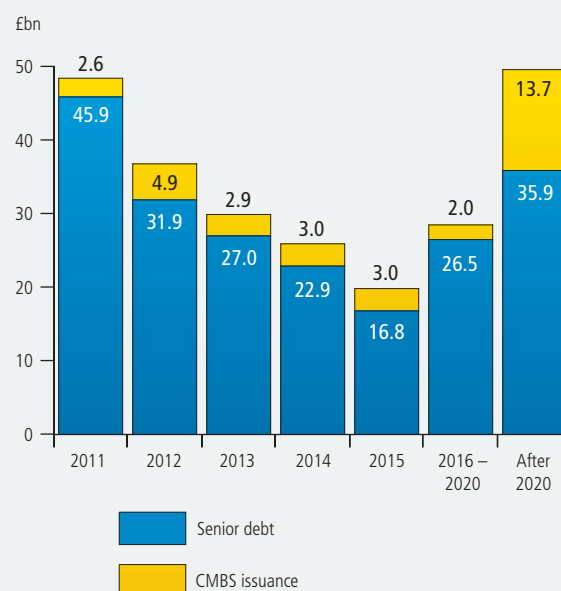
Debt repayment

Between 2011 and 2015 inclusive, 69.5% of all outstanding debt is due for repayment – see Figure 7. This proportion is lower than the 71% proportion of debt due to mature within the following five years that was recorded at year-end 2009, but is similar to the 69% recorded at year-end 2008. However, it is still significantly higher than the proportions recorded by this research in previous years, for example, at year-ends 2006 and 2007, the proportion of debt due to mature within the following five years was 61% and 60% respectively. It is suggested that the reason for this change in maturity profile is that lending organisations continue to extend loans that were due to mature after 2008 because of the borrowers’ inability to refinance their loans. The research suggests that up to around £14bn of debt from £52.6bn that should have matured in 2010 has been extended with particular concentrations in 2011 and 2013. However, this is much less than the £30.4bn of additional debt recorded as being extended when carrying out the same exercise at year-end 2009 for loan maturities in years 2010 to 2012.

The lower volume of extensions recorded in 2010 is a consequence of loans being transferred to NAMA and other overseas agencies and organisations actively reducing the value of outstanding debt by repayments and the disposals of assets.

Figure 8 presents the aggregated loan books allocated by value between prime and secondary property. This is the first occasion that this particular data has been requested. Not all organisations have the information management systems in place to recall this data. Also, the interpretations of ‘prime’ and

Figure 7: Maturity profile of debt secured on UK commercial property



Sources: De Montfort University; Fitch Ratings

‘secondary’ was left to the discretion of the respondents to the question, as it is throughout the questionnaire. Organisations holding 62% of the aggregated outstanding loan book of £206.9bn responded to this question. If the proportions recorded by All Lenders are applied to the total value of outstanding debt of £206.9bn recorded by this research, then this suggests that approximately £79.3bn of debt is secured by prime property and £127.6bn by secondary property.

Figure 8: Allocation, by loan book value, between prime and secondary property

Category of lender	Prime %	Secondary %
UK Lenders and Building Societies	31	69
German Lenders	55	45
Other International Lenders	43	57
North American Lenders	19	81
All Lenders	38	62

3 Ibid

Loan terms

Typical loan lengths

The reduction in the typical length of loans secured by investment property identified since 2006 virtually ceased between 2008 and 2009. In 2010, 90% of all investment loans were written for a period of up to seven years duration but with five years being the most frequently cited length. This compares with 88% recorded in 2009, 84% in 2008 and 77% in 2007. The most frequently cited loan length in 2009, 2008 and 2007 was also five years. The average length of an investment loan was 5.4 years in 2010. This is longer than the 4.7 years recorded in 2009 and 2008, but shorter than 6.7 years recorded in 2007.

With regards to the length of time that it was estimated that an investment loan would actually remain in place, this was recorded at 3.9 years at year-end 2010. This compares with 4.2 years at year-end 2008 and 4.3 years at year-end 2009.

In 2007 and 2008, 52% and 48%, respectively, of development loans were written for a period of two years or less. During 2009, this increased to 76%. At year-end 2010, this proportion had fallen back to 65%. Within the small number of responses to this part of the research, the data and comments suggest that much of the development finance available during 2010 was for new residential development primarily located in the South East.

The research since year-end 2009 requests information in relation to the typical length of extensions given to maturing loans. For investment loans maturing in 2010, the responses show that the range in length of extended loans was from six months to 10 years. This compares with a range of nine months to five years recorded at year-end 2009. The most frequently cited length was two years in both 2009 and 2010 whilst the average of all respondents was 2.58 years at year-end 2009 and 2.21 at year-end 2010. The quality and reliability of the borrower, together with the cost of funds, were key factors in the decision of how long an extension to give.

Lending limits

With the exception of German Lenders, overall borrower limits increased during 2010. However, the responses indicate that there are complex issues involved in this particular decision and many organisations do not have pre-defined limits. Lending limits are most often related to the lending organisations' capital base, under current Basle II regulations and the impending capital requirements under Basle III. German Lenders also commented on the importance of satisfying the criteria relating to Pfandbrief issues. Lending organisations are currently focusing on key borrowers, with whom they wish to develop relationships. This is a possible explanation for the increase in borrower limits recorded at year-end 2010.

Average margins

Average margins at year-end 2010 were the highest recorded by this research for each property sector. For example, the average margin on loans secured by prime office property increased from 219.7bps at year-end 2009 to 229.8bps by year-end 2010. Similarly for secondary offices, average margins rose from 254.0bps at year-end 2009 to 267.5bps a year later.

Average loan-to-value ratios

During 2010, the average loan-to-value ratio secured by prime office, prime industrial, secondary industrial and residential investment all rose. In contrast, those secured by prime retail, secondary office and secondary retail all declined slightly.

The increase in average loan-to-value ratios from year-end 2009 to year-end 2010 ranged between 0.2% and 0.7%. For example, the average loan-to-value ratio for loans secured by prime offices increased from 66.8% to 67.0% and for prime industrials, from 64.1% to 64.9%. The decline in average loan-to-value ratios ranged between 0.04% and 0.5%. The ratio for loans secured by prime retail fell from 66.8% to 66.3% during the year.

Average arrangement fees

For the first time since year-end 2005, there was a decrease in the average fees applied to loans secured by all types of commercial property except for secondary retail, which increased by 0.5bps from 108.1 to 108.6bps over the year. The smallest reduction in the average arrangement fee was recorded for prime industrial, from an average of 101.4bps to 98.4bps. The lowest average arrangement fee recorded at year-end 2010 was 94.7bps, for loans secured by prime office property.

Average income-to-interest cover

During 2010, base rates remained unchanged, swap rates increased and property yields fell, especially for prime property. Overall this resulted in income-to-interest cover ratios falling for loans secured by prime property between year-ends 2009 and 2010.

Loans over £100m

Only eight organisations (14% of the total sample) indicated that they were in the market to lend £100m or above. This group comprised five German Lenders, two Other International Lenders and one UK Lender. All these organisations confirmed that the interest rate margin would increase. The increase in pricing ranged from 5bps to 50bps. Higher fees were also likely to be charged but no detail was given. An additional three organisations responded that they would consider loans of this magnitude if they were part of a syndicate or club.

Extended and restructured loans

The consensus view from respondents was that where possible, extended and/or restructured loans would ideally be on the same terms as for new lending. However, this general response was subject to a number of classifications. In most instances, the terms for a restructured or extended loan would be 'deal specific' and based on the relationship with the borrower. Thus, the terms would have to take account of the exact circumstances of the loan being extended or restructured. In virtually all cases, the loan-to-value ratio would be at a level at which the lending organisation would not currently lend. In these circumstances, and if the existing income will support it, an increase in margin will be applied. The extent of the increase will depend on the risks of the situation. In some instances the tranche of the loan above a current senior debt level will be priced as mezzanine. The senior debt element would be at a margin current in the market but that on the mezzanine element would be between 800bps and 1000bps. In other circumstances a 100bps will be added to the existing margin and a full cash sweep taken of all surplus income. A key element in determining the pricing was whether or not the lending organisation itself had to borrow money to extend the loan.

If the existing income did not support an increase in margin, then extension fees of between 25bps and 50bps would be incurred together with exit or back-end fees of another 100bps. More favourable terms would normally be considered if the borrower(s) provide new equity and the security of the lending organisation position improves compared to the existing situation.

Junior debt and mezzanine on investment loans to commercial property

At year-end 2010, and for prime offices and prime retail property, one organisation was prepared to provide both junior debt and mezzanine finance and another three organisations, mezzanine finance only. This compares with nine organisations that were prepared to provide funding above a senior debt level at mid-year 2010, and six organisations at year-end 2009. The range of senior debt loan-to-value ratios offered by those organisations prepared to consider the additional forms of finance was 65% to 70%. For junior debt, the loan-to-value ratio was 75% and for mezzanine finance, the range was from 75% to 85%. Interest rate margins ranged from 190bps to 300bps for senior debt, 350bps for junior debt and ranged from 500bps to 900bps for mezzanine finance.

Hedging strategy

With regard to new loans written during 2010, 77% of organisations always require an agreed interest rate hedging strategy to be in place. This proportion is a decline from the 85% reported at the end of 2009 and a return to the same proportion as reported at year-end 2008. Of the remainder, 8% only 'sometimes' require a hedging strategy to be in place, whilst

15% do not require a strategy to be in place at all. Those organisations that answered 'no' tended to be those that stated they were 'short-term' lenders.

Loans in breach of financial covenant and defaulted loans

'In breach of financial covenant' is defined in the survey as meaning loans where interest and/or principal repayments have been wholly or partly unpaid and/or the loan-to-value ratio or other covenants have been breached but the loan has not been declared in default. A default is defined as meaning loans where the borrower has breached its loan obligations and the lending organisation has decided to accelerate the loan.

At year-end 2010, 50 (76%) of the 66 lending teams and respondents to this question, reported that their organisations held loans that were in breach of financial covenant. A further nine lending teams, 14% of respondents, reported that they did not hold any loans in breach. At year-end 2009, 88% of respondents reported that they held loans that were in breach of financial covenant.

Figure 9: Number and value of loans in breach of financial covenant

Year-end	No. of loans in breach	Value in breach	Value of aggregated loan book
		£m	%
2005	689	1,225	Less than 1
2006	1,928	4,234	2.5
2007	1,051	1,597	Less than 1
2008	3,770	10,695	6.5
2009	3,665	28,305	15.5
2010	7,733	21,975	12.0

The decline in value of loans in breach of financial covenant recorded between year-end 2009 and 2010 is believed to be a result of a number of factors. Loan transfers to NAMA will have included distressed loans held by those organisations that are part of the asset transfer programme and these are not included in the data reported to this research. Also, lending organisations, generally, are taking a variety of measures to tackle their problem loans. These include the restructuring of loans, perhaps aided by the borrower injecting extra equity or providing additional guarantees. Thus, the loans would become performing again and be removed from the data for distressed loans.

Alternatively, loans may be classified as in default. In these circumstances, the lending organisation will encourage the borrower to dispose of the property assets, (where market conditions are conducive to do so) and make repayments. The

lending organisations may even take control of the underlying property assets. In both of these situations, the loan will no longer be classified as in breach. It was also commented that the recovery of capital values of specific market sectors had helped to reduce the number of loans in breach of their loan-to-value covenant.

With regards to loans that had actually defaulted, 52% of lending teams reported that they had taken action to accelerate repayments. This compares to 62% and 66% that did so at year-ends 2009 and 2008 respectively. A further 36% reported that they had not taken such action at year-end 2010, whilst 12% were unable or unwilling to respond.

The value of defaulted loans of £15.38bn shows a decline from the £19.33bn reported at year-end 2009. However, as will the data recorded for loans in breach of financial covenant, the decline in value of loans in default will, in part, be a consequence of the value of loans transferred to NAMA. The value at year-end 2010 represents 10% of the aggregated loan book of those organisations that reported in detail. If this proportion is applied to the total value of outstanding debt recorded by this research (£206.9bn), this would suggest that approximately £20.7bn of loans may have been in default at year-end 2010. With regards to the reasons given for loans to be declared in default, tenant default, lease expiry, voids and the subsequent decline in rental income and cash flow was cited much more frequently than in previous surveys.

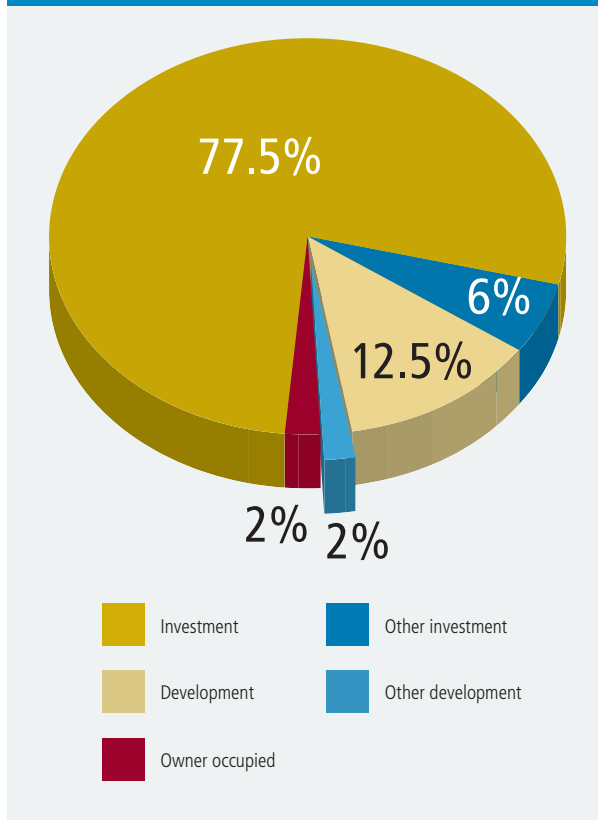
Defaults continued to occur with residential and commercial development schemes. Speculative commercial developments failed to find tenants on completion and capital values plummeted. Similarly, completed residential development schemes failed to sell at values to repay the amount of the original development loan. The problems with residential schemes were, in terms of location, identified as in the Midlands, Northern England and East Anglia. London and the South East were viewed as being 'far less troublesome'.

Structure of outstanding loan books

Type of project

Figure 10 shows the proportion of the value of aggregated loan books that is allocated to the different types of commercial property project in 2010. The proportion allocated to development overall fell from 15% at year-end 2009 to 12.5% at year-end 2010, with the proportion allocated to commercial property development falling from 6% to 4.75%. The proportion of outstanding debt allocated to investment property, which declined between 2003 and 2007, increased from 76% at year-end 2009 to approximately 77.5% at the end of 2010.

Figure 10: Proportion of total value of lending by type of project 2010



Type of property

Comparing the results for 2010 with those of 2009, there has been small changes to specific sectors of loan book allocations. Retail, distribution and warehouse and 'other' have experienced reductions in loan book allocations. In contrast, office and business parks, industrial, social housing and hotels and leisure have experienced increases in loan book allocations. In particular, student housing and nursing homes and the health sector generally were cited by organisations that reported 'other' investment lending.

Regional allocation of lending

At the end 2008, there was a concentration of 52% allocated to London and the South East, by the end of 2009 the concentration had fallen to 45% and this fell again at year-end 2010 to 44%.

International lending

At year-end 2010, £23.5bn of outstanding debt was reported as being secured by commercial property situated outside of the UK. This is in addition to that secured by UK commercial property. This decline of 50% from the comparable figure recorded for year-end 2009 of £46.9bn is almost entirely due to changes in operations by German Lenders. Three German Lenders have

Figure 11: Future lending intentions

Categories of lender	Increase loan originations (%)		Maintain loan originations (%)		Decrease loan originations (%)	
	2009 year-end	2010 year-end	2009 year-end	2010 year-end	2009 year-end	2010 year-end
UK Lenders and Building Societies	33	26	21	26	46	48
German Lenders	75	69	19	19	6	12
Other International Lenders	59	57	5	5	32	38
North American Lenders	16	67	16	0	68	33
All Lenders	50	50	18	15	26	35

moved their non-UK operations back to Germany and thus are no longer originating overseas lending out of a London-based office. Other German Lenders have curtailed their lending outside of Germany quite significantly.

Lending intentions

Figure 11 shows the intentions of lending teams in terms of loan originations as at year-ends 2009 and 2010. Within the individual categories of lenders there have been changes in intentions, with the proportions of UK Lenders and Building Societies, and German Lenders intending to increase loan originations both falling. This is offset somewhat by an increase in North American Lenders intending to increase loan originations during 2011. The proportion of lending teams intending to maintain the value of loan originations has remained broadly consistent between year-ends 2009 and 2010.

The 35% of lending teams intending to become less active only completed 7% of the value of loan originations during 2010. Five lending teams intending to increase loan originations during 2011 completed no lending whatsoever during 2010. The intentions for 2011, therefore, indicate a positive move to re-enter the lending market. However, with an estimated £45.9bn of loans due to mature during 2011, the magnitude of the funding gap that exists in the market is clear.

Conclusions

During the latter half of 2010, a number of the issues identified in previous reports and forecasted to have an impact on commercial property lending were beginning to take effect. The banking industry generally is perceived to be of higher risk than previously by the financial markets. This, together with the influence of the Basel III regulations that have been factored into interest rate margins, increased the costs of borrowing to both lender and borrower. In turn, this has prompted lending

organisations to ration capital and lending business generally. Consequently, organisations only seek commercial property lending opportunities supported by the highest quality property asset and borrower.

The UK economy remains weak and it is still difficult to quantify the impact of government austerity measures. Regional economies are perceived to be particularly vulnerable to cut backs in public spending. Secondary and tertiary property values remain depressed and it is these sectors that constitute the bulk of the legacy loan books of many lending organisations. Whilst the overhang of legacy debt remains in place, it will prevent many lending organisations from re-entering the market. The loans held by NAMA, although removed from the balance sheets of lending organisations, continue to be problems that have to be resolved. To address this situation in the short term, new sources of finance to the commercial property market are required. This could include the re-opening of the CMBS market, albeit with much simpler and more transparent structures than in the past. Solvency II may encourage more insurance companies to enter the commercial property lending market, although their involvement may also be restricted to the best quality property transactions.

However, 2010 may have marked the start of the recovery in the UK commercial property lending industry. There has been a measured reduction in outstanding debt that has, so far, avoided off-loading property assets to the detriment of the market and capital values. The rate of increase in impaired loans appears to be slowing and new loan originations are cautious in nature and based on conservative terms. In the longer term, the industry needs to address a number of related questions. What is the role that debt has to play in the property investment market? Is there a level of sustainable debt that the market can support and, if so, on what terms?

Property cycles and gearing levels

It has been three years since the start of the great financial crisis and its legacy is still with us. If the root of the problem was over-gearing in the banking sector, the property sector was no exception. Property is a very cyclical industry and it ought to be intuitive that gearing be adjusted accordingly. The problem with intuition is that it is often corrupted by the excitement of times.

The Grosvenor Group research team decided to investigate the potential of using a single indicator (instead of many different ones) to help set gearing levels in property portfolios and make them more systematic, hence minimising risk, enhancing returns and maximising NAV growth. Investors would then have a better chance of ensuring that gearing is low at the top of the cycle, high in the trough and the early upswing and moderate in the final part of the upswing.

Choosing the right indicator

To be useful in setting the level of overall gearing in an international property company a property cycle indicator needs to be:

- Market driven – not subject to the errors that can arise in official data, nor surveys that can be affected by sentiment;
- Timely – available shortly after the month or quarter end to which it applies;
- Smooth – providing a clear rather than a 'noisy' or ambiguous signal; and
- Predictive – reliably moves up or down in advance of average commercial property values.

We evaluated a wide array of economic variables in order to construct a global property cycle indicator including: stock market indices, bond rates, property spreads over bonds, GDP growth, national and international output gaps and indices of property rents and yields. We found the global office yield composite indicator to perform the best in setting gearing levels.

This is a composite index of the Grade A capitalisation rates (prime initial yields) from some of the most important office markets around the world. Office markets in the world's leading cities are preferred over retail ones as they are linked to stock markets which, in turn, anticipate economic growth. The larger office markets are highly liquid and dominated by the larger, more sophisticated investors and so tend to 'price' future rental movements more quickly and efficiently than other parts of the property market. Figure 1 shows the global office yield composite index. Together with the 'raw' index: a simple arithmetic average of the key office market yields, the version of the index weighted by the liquidity of each market is also shown. Various weighting systems have been tested but it is liquidity which most improves the predictive ability of the indicator¹. This is the indicator we adopted.

Using the indicator

In order to benchmark the phase of the cycle and make a gearing recommendation, we used the indicator's long-term average and the long-term average plus and minus one standard deviation as boundaries (as seen in Figure 1). The cycle is split into five phases: peak, downswing, trough, upswing-low, and upswing-hi. The latter two phases might also be termed the early upswing and the late upswing. Specifically:

- A trough is when the index is above the plus one standard deviation line;
- A peak is when the index is below the minus one standard deviation line;
- The market is in downswing phase when the index is moving up between peak and trough;
- The upswing-low phase is when the index is moving down between the plus one standard deviation and the long run average; and
- The upswing-hi phase is when the index is approaching the minus one standard deviation line.

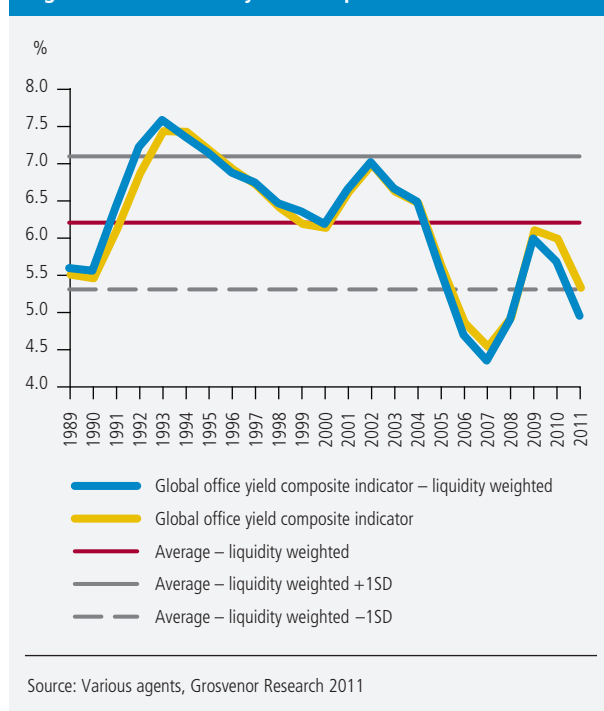


Richard Barkham,
Grosvenor
Research



Cynthia Parpa,
Grosvenor
Research

Figure 1: Global office yields composite



¹ The index is relatively smooth and gives a clear signal of the peaks and troughs of the global property market. Moreover, the peaks and troughs broadly accord with how the property market behaved over the period. The troughs (as indicated by the index peaks) are in 1992, 2001 and 2009. The peaks are 1989, 1999 and 2006. On this, admittedly limited, evidence the global property cycle appears to be getting shorter and more powerful.

We assumed a conservative approach to gearing and hence a desired maximum gearing level of about 70%. The minimum gearing was set at 30%. The very simple decision rules we used to convert the phase of the cycle to a gearing recommendation are:

- Peak – gearing is at minimum: assumed to be 30%;
- Downswing – gearing is minimum: assumed to be 30%;
- Trough – gearing is maximum: assumed to be 70%;
- Upswing low – gearing is maximum: assumed to be 70%;
- Upswing hi – gearing is at medium: assumed to be 50%.

Obviously these simple rules can be revised according to the risk tolerance of the fund or company using them. Our rules are for exploratory purposes only.

Figure 2: Results of analysis

Indicator	Global office yield composite %	Constant gearing 30% %	Constant gearing 50% %
Property return p.a. – average	7.8	7.8	7.8
Equity returns p.a. – average	8.6	7.7	7.6
Property return after tax p.a. – average	4.7	4.7	4.7
Equity returns after tax p.a. – average	4.9	4.3	4.0
Property return p.a. – annualised	7.3	7.3	7.3
Equity returns p.a. – annualised	7.5	6.8	6.3
Property return after tax p.a. – annualised	4.3	4.3	4.3
Equity returns after tax p.a. – annualised	4.0	3.5	2.9
Standard deviation of property returns	10.4	10.4	10.4
Standard deviation of equity returns	14.9	13.7	15.9
Risk-adjusted property returns	0.75	0.75	0.75
Risk-adjusted equity returns	0.58	0.56	0.47

Note: Period of analysis: 1989-2010
Source: Grosvenor Research 2011

Results

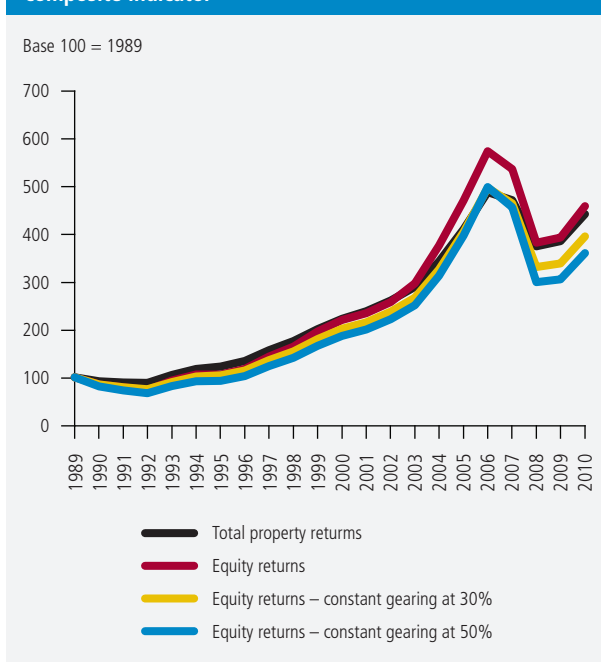
We tested the impact of setting gearing according to our indicator on the returns of a simulated property investment company². For comparison purposes we also tested two further scenarios where gearing is kept constant at the minimum level of 30% and at a medium level of 50%. The results from all simulations are summarised in Figure 2³:

It can be seen that, if this rule had been used in the past (as it could have been since it relies only on existing data), average equity returns would have out-performed un-g geared property returns, over the period analysed. The indicator provides better equity returns (average and annualised both before and after tax) than a 'naïve' approach where gearing is kept constant over the cycle.

Using gearing increases the volatility of the returns and, as expected, risk-adjusted equity returns using any of the approaches above are lower than un-g geared risk-adjusted returns. That said, the use of the global composite yield indicator provides better risk-adjusted equity returns compared to a 'naïve' gearing approach.

Figure 3 shows the equity growth (before tax) over time under the above scenarios. It can be seen that setting gearing according to the indicator enhances NAV growth over the long run.

Figure 3: Returns using the global office yield composite indicator



Source: Grosvenor Research 2011

² A simulated balance sheet of a UK property investment company was used as a proxy. Property returns are derived as per the IPD UK All Property index (from 1989 to 2010). Acquisitions and disposals are assumed according to debt level movements, i.e. when gearing increases assets are acquired and when gearing needs to decrease assets are sold to repay debt. Loan interest is calculated using the relevant five-year swap rate plus a margin of 120 bps. Effective tax rate is taken as 28%.

³ Returns are calculated over the period of 1989 – 2010. Average returns are the arithmetic average of annual total returns. Annualised returns are compounded annual returns. Risk adjusted returns are average returns divided by the standard deviation of returns.

Conclusion

The global office yield composite indicator, provides recommendations that are cautious and in line with the long-term history of the property cycle. Using the indicator helps enhance average equity performance in the long run (before and after tax) and improves NAV growth compared to a 'naïve' approach where gearing is kept constant. In addition, it is a simple rule and places the most emphasis on the current position of the property market relative to its long-term history.

However, the current level of the indicator shows property to be overpriced and indicates that gearing should now be set at the minimum level of 30% (equivalent LTV 23%).

It is possible that the office yield series trends downwards and so the long-term average (and associated standard deviations) is 'too high'. Statistical tests show that the average yield since 2000 is 100bps lower than in the period 1989 to 1999. However, it is far from clear that we should ignore the signal produced by the long-term average. It could be argued that the last 10 years are unique: it was the era of 'cheap capital', extreme gearing in the banking sector and super-loose monetary policy.

The current situation is very unusual from a historical perspective. Yields are low despite the fragility of the global economy and high levels of vacancy in property markets. The answer, no doubt, lies in the monetary arena, with quantitative easing being the most likely culprit. This suggests that we should focus on the signal from the long-term average and keep gearing at low or moderate levels for the time being.

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Where next for Irish property?

As I am writing this, I have just read that Brian Lenihan, Irish Finance Minister from 2008-11, has sadly died at the age of 52. I am reminded that in his December 2010 Budget speech he quoted Abraham Lincoln, saying, "If we could first know where we are and whither we are tending, we could then better judge what to do and how to do it". This quote remains pertinent to the Irish economy and hence the Irish property market today.

I am fascinated by the dynamics of the relationship between property and the banking system and in my recent role with NAMA (Ireland's National Asset Management Agency) I was privileged to work close to the centre of events in a country facing bankruptcy – a period during which economic history has undoubtedly been made.

A recent history lesson

The Irish banking crisis was certainly prompted to some degree by the international financial crisis. But what made the Irish property market cycle so pronounced and why did it bring the country's banking system to its knees?

It is helpful to delve a short way back into Irish history. Until the late 1980s, Ireland had a lower standard of living than most of its neighbours and a third of the population lived below the poverty line. Rapid export-led growth in the Irish economy in the period from the early 1990s to 2000 was driven by a combination of the elimination of trade barriers, the persistent lowering of the corporation tax rate and a young, well-educated population profile.

So what went wrong? When Ireland joined the EMU single currency it lost the accustomed ability to devalue regularly to counter the effect of large rises in the cost base. Competitiveness was lost and export-led growth stalled. Banks had not been central to financing the economic growth in the 1990s but, subsequent to joining the euro, the Irish banks found themselves with access to unlimited credit on the interbank market at low rates and with no exchange rate risk. Credit was growing at 20%-30% a year – a significant multiple of nominal GDP and a recipe for a bubble. The Irish banks borrowed between €100bn and €200bn from overseas to fund their Irish business and they increased the share of their assets in property-related lending from less than 40% before 2000 to over 60% by 2006.

By 2006, nearly 25% of GDP was derived from the construction industry (in most economies the equivalent figure is under 10%). Extra public spending was funded by tax from VAT and stamp duty on property. Between 1994 and 2006 the average price of a Dublin house rose by over 500%.

The price bubble fuelled a sharp increase in construction – the idea that Ireland could absorb 90,000 new dwellings a year (as happened in 2006) was absurd. By comparison, the UK, which has a population 14 times that of Ireland, produced only around twice the Irish housing output. The planning system must bear some of the blame for the crisis.

The Honohan Report identified a number of factors believed to have contributed to Ireland's banking crisis. It concluded that not only were there significant breakdowns in risk management, both within the banks and in supervision of the financial sector, but also serious breaches of corporate governance were overwhelmingly important.

The bank guarantee

On the night of 30 September 2008, amidst the chaos of the international financial crisis, the Irish Government guaranteed €440bn of liabilities for six Irish financial institutions: Bank of Ireland; Allied Irish Bank; Anglo Irish Bank; Irish Life and Permanent; Irish Nationwide building society; and the Educational building society. The Irish economist, Morgan Kelly estimated the losses of all the Irish banks at roughly €106bn. Anglo alone faced losses estimated at €34bn out of a total loan book of around €72bn, most of which was to Irish property developers.

The question has been asked as to why the Government did not simply guarantee deposits, to which Lenihan responded that the Irish banks were governed by English law, which gave bondholders the same status as depositors. Presumably, however, the Government could have changed the provisions of the law had it so wished?

The birth of NAMA

The announcement of the setting up of the National Asset Management Agency (NAMA) in the Budget of April 2009 followed.

During the frantically busy period up to the end of 2010, NAMA acquired approximately €71.2bn par value of loans from the six participating institutions and paid consideration of approximately €30.2bn. This was based on a formula comprising a combination of property valuations at November 2009 and a 'long term economic value' premium (judged to be on average 10% of the market value of loans in the early tranches of loans acquired and sometimes referred to as the 'State Aid premium'). A haircut was applied to the loan values on this basis.

It now looks as if November 2009 was not the bottom of the market (one influential index currently suggests that an appropriately weighted basket of property would have to rise in value by 12.9% to equal the sum paid by NAMA for the loans). The initial estimate of the average haircut increased from 30% in September 2009 to 58% at the end of 2010. NAMA said this was largely a result of the due diligence process revealing deficiencies in such matters as documentation and other details. Whatever the reason, the effect has been to crystallise larger than anticipated losses on the banks' balance sheets.

According to published sources, roughly 80% of NAMA assets relate to commercial property loans and 20% to residential property loans. Approximately 66% of assets relate to property



Shirley Smith

in the Republic of Ireland; 5% in Northern Ireland; 21% in the rest of the UK and 8% elsewhere.

Consideration for the loans was paid to the banks in the form of 95% senior bonds and 5% subordinated bonds. The subordinated bonds will not be honoured in 2020 if NAMA does not at least break even. If NAMA makes a loss (over its intended lifespan of 7-10 years) a levy will be imposed on the participating banks. Given that most of the banks now seem headed for State control; if not there already, these arrangements now appear circular.

The original idea was that NAMA would take toxic loans off the banks' balance sheets, funded by cheap (!) money from the European Central Bank (ECB), thus freeing up credit flows. It was also anticipated that benefit would be derived from NAMA providing a 'floor' of certainty regarding the value of property related loan assets. However, subsequently there has been debate as to whether NAMA may have contributed to the escalation of the crisis by immediately crystallising losses on the banks' balance sheets.

Loss of sovereignty

In November 2010, after a period of uncertainty and confusion and the drying up of international credit and withdrawal of corporate credits from Irish banks, an €85bn financial rescue was agreed with the EU/IMF. Funds were made available to July 2013 at a blended interest rate of 5.8%. Conditions included more rigorous stress testing for the banks and capital injections to stabilise the banking system. It has been mooted that a further condition was that senior bondholders in the banks would not be made to share the pain. Crucially in the minds of many, the controversial 12.5% corporate tax rate was not sacrificed.

The cost of insuring against Irish sovereign default did not fall sharply in the wake of the bailout – an indication of the market's continuing lack of confidence. A period of intense political turmoil followed. The Government managed to remain in power long enough to pass the December 2010 Budget, which contained measures aimed at reducing the deficit to 3% of GDP by 2014 in order to comply with the bailout requirements. These measures include €15bn of fiscal adjustments (€10bn from expenditure cuts and €5bn from additional revenue) and are predicated on average GDP growth of 2.75% over the period 2010-14 and the retention of the 12.5% corporate tax rate.

After the February 2011 election, the Government was replaced with a Fine Gael/Labour coalition, thus ending many years of Fianna Fail domination of the political scene. Some have suggested this may encourage international confidence in Ireland by being seen to lessen the close ties between business and politicians. (Both Fine Gael and Labour were originally against the creation of NAMA).

Burning the bondholders?

Stress losses now being provided for in the Irish banking system, subsequent to the March 2011 tests, if fully realised, would push loan losses to over €100bn. Sizeable losses have already been taken by subordinated bondholders and controversy reigns as to whether they should be required to share the burden of the extra capital now required. Senior bondholders remain immune.

Any default of the banks would effectively now be a bill presented directly to European governments. Local commentators have suggested it is dangerous for a country to rely on foreign sources for the continuation of its banking system, especially given continuing instability in the eurozone.

Where to now for the economy?

The Irish economy has shrunk for the fourth year in a row and per capita GNP in Ireland has fallen by 16% from its peak. GDP is forecast at 0.75% for 2011 and 2.5% for 2012.

Unemployment is close to 15%. The current account balance of payments is forecast to be in surplus in 2011 but this draws attention to the continuing debate within Europe over Ireland's advantageous 12.5% corporate tax rate – the OECD has estimated that a 1% increase in corporate tax could lead to a 3.7% fall in foreign direct investment.

Markets have already assumed the country will not be able to return to the debt market in 2012, recent attempts to renegotiate the bailout have collapsed and a further bailout looks likely. A 'twin track' Europe now seems a distinct possibility and a split in the euro or an exit from the euro would be likely to result in a sudden massive devaluation for the Irish currency.

Massive political controversy has been raised regarding the effective transfer of private losses to the public realm, and hence taxpayer and citizen. The economic question remains as to whether this will have been worthwhile.

What does this mean for the property market?

IPD estimated that there was a 60% fall in commercial property values in the three years to the end of September 2010 and the Irish Central Statistics Office figures show there has been a fall of 47% in Dublin residential property values since early 2007. DTZ has suggested that Ireland is the most vulnerable commercial property market in Europe as it faces the biggest funding gap relative to its size – equivalent to approximately 16% of the value of Ireland's commercial property market.

A few commercial sales have taken place (most notably to Google) but the market has been 'stuck' for some time. If overseas money is not enticed in, locally-funded purchases will have the effect of further shrinking the money supply. The Government wants to create a REIT regime to provide a conduit for overseas capital and NAMA is investigating this option. As the third largest lender to the UK commercial property market,

NAMA has also, somewhat controversially, announced recently that it intends to sell all its UK property assets by the end of 2013.

Commercial prices have now fallen to a level where, with average equivalent yields in the region of 8% and theoretical funding costs at a much lower level, purchases would normally begin to look attractive. However, the yield on Irish Government bonds has risen sharply so competing investments begin to look interesting (and for an overseas purchaser, the risk on Irish commercial property is pretty much equated to the risk on the Irish economy). Overseas purchasers are crucial and may be discouraged by the possibility of a future disintegration of the euro.

There are signs of banks more aggressively deleveraging and NAMA appears to have reached a more active phase in its operation, having worked through debtor business planning and formulated strategy. A number of receivership appointments by NAMA in the last quarter also suggest an increase in sales activity. It must be assumed there is some level of EU/IMF pressure on NAMA to realise funds over the period to July 2013. The danger is that the market will be flooded which will further depress prices. Expectations for any rental growth are low given general economic weakness and high past rental growth. Focus on preservation of income and asset management is anticipated and a divergence between prime and secondary returns (as has been seen in the UK) is an expected result of both this and the likely predominance of overseas investors.

To add to the uncertainty, the Irish Government has announced legislation providing for downward reviews of rent in leases. This was intended to ease the burden for ailing businesses, in particular the retail sector. Uncertainty remains over whether this will include a retrospective provision for existing leases. A significant industry lobby has claimed this legislation could cause a further 20% fall in property values, impacting NAMA, pension funds and the banks.

In the housing market, affordability has reached levels last seen in 2001, rental yields have risen to levels not seen since 2003 and transaction costs have fallen as a result of the slashing of stamp duty. However, incomes are still falling, unemployment is high, mortgage finance remains extremely tight and a significant overhang of property remains (although the first net decline in mortgageable housing stock ever has been recorded in Q1 2011). Ireland already has one of the highest levels of home ownership (87%) and any recovery is expected to be slow, in line with recovery in the economy.

Buying into the Irish market in 2011 might be well timed – but it is an extremely high-risk bet on Irish economic recovery and the eurozone remaining intact.

Property by nature, property by investor

Report on the IPF Conference in Scotland

The eighth annual IPF Property Investment Conference in Scotland, sponsored by Dundas & Wilson and Miller Developments, took place in Glasgow on 3 June. The line-up of industry experts considered the impact of financial and regulatory changes on the UK property market and, against this backdrop, whether property is still an attractive asset class for institutional and private equity investors.

The event was chaired by IPF Scotland Chairman, Paul Findlay of SWIP. Welcoming everyone to the conference, he commented that 2010 had been far more positive than some had predicted at last year's conference, where there had been talk of a possible "long period of grisly, grinding difficult times".



Looking ahead, he said that SWIP was forecasting an improvement in rental growth over the next three years, with retail property coming back post 2013. Capital declines are still expected in 2011, but growth forecast in 2012. Central London is expected to outperform the regions over the next three years. With a forecast 'All Property' total return of 7.1% pa, property looks competitive compared with other asset classes.

Phil Clark of Aegon Asset Management and incoming IPF National Chairman looked at the increasing financial and regulatory burden on the property market, affecting virtually every level from the direct asset upwards. In terms of regulation, he mentioned amongst others the lease accounting rules, competition law and land transactions, the FSA Remuneration Code, the Alternative Investments Fund Manager Directive and the European Market Infrastructure Regulation (EMIR).

He then focused on Solvency II and Basel III. With regard to the former, he said that the provisions as they currently stand would have a major impact on geared investment funds. However, from a positive perspective, Solvency II should encourage insurance

companies to lend against direct property, going some way toward filling the gap in availability of debt finance. Basel III will discourage the banks from taking high exposure positions to property, thereby lowering loan to value ratios and the amount of lending to property overall.

The work undertaken since 2009 by the Property Industry Alliance Debt Group highlights how many loans are being extended and the relatively low level of new debt available – £10-15bn out of a total of £243bn of outstanding debt at the end of 2010. The Debt Group has estimated that the sustainable level of bank lending in the property sector is around £100-150bn so there is a considerable amount of deleveraging still to come. As an industry, "we need to make adjustments to less debt as it is not just a short-term issue. However, this is an entrepreneurial industry and we have the ability to adapt and change".

James McCann of RBS said that the UK economy, "had climbed out of the winter of recession but the spring is still pretty chilly". So where is future growth likely to come from in the next two to three years? Probably not from consumption, which constitutes two-thirds of the economy, given the high levels of household debt, falls in real incomes and levels of unemployment, particularly amongst under-25s. The budget deficit will also be a drag on growth and employment. Conversely investment is in fairly good shape with production rising and corporates holding a lot of cash – equivalent to 5% of GDP. He expected to see a pick up in investment, either through mergers and acquisitions or fixed capital.

The UK economy needs to move away from domestic demand and export more and to different markets. At present we export more to Ireland than to Brazil, China and India put together. In terms of imports, McCann thought these would remain relatively low and that there would be more domestically produced goods. Nevertheless, it would take us five years to get the economy back to where it was in 2008.

On inflation, he was fairly sanguine, as he expected this to cool over the next 18 months, based on spare capacity in the economy and the current low wage inflation. He anticipated that interest rates would rise in August 2011 but not rapidly.

Based on this slow economic recovery scenario, he expects, "the property market to tread water. There will be little scope for prices to go anywhere, although there may be greater divergence between prime and secondary".

Looking at the risks to the recovery scenario, he highlighted three key areas: the danger that the underlying economy fails to compensate for public sector cuts, resulting in an increase in gilt yields and from a property perspective impacting property yields and tenant demand; Inflationary pressures being greater than anticipated if there are more shocks, i.e. energy prices, or the capacity in the market has been overestimated. This would lead to increasing interest rates; and thirdly a crisis in the eurozone. A general downturn would affect the UK's export market and

Conference speakers (left to right): Bill Hughes, Nick Berry, Phil Clark, Paul Findlay, James McCann.



should Spain be under pressure, he thought that the UK's position would be re-assessed by investors.

Given the prevailing economic conditions, how do institutional investors view the property market? Bill Hughes of Legal & General Property outlined his thoughts on the excessively traditional approach to the sector by investors, the 'unusual' current market and how Legal & General is responding to this. In his opinion, most of the accepted wisdom as to the diversification benefits of property are overstated – during the financial crisis property and equities went down together and the relationship between the two is growing ever stronger. Property has not proved to be a true hedge against inflation; over a 30-year period, there has been a reasonable relationship between rental growth and inflation but not in the short to medium term. He also questioned the narrow approach to managing risk, with **"the seeming fixation on matching IPD sector/regional spread"**, the requirement for liquidity across the whole portfolio, investment in 50-60 properties to minimise specific risk and investment solely in 'A-rated' covenants.

We are going through very unusual times. Bank lending to the property sector is at unprecedented levels, there is far less new lending and banks are reluctant owners. Given that many institutional investors are long on cash; this could be an opportunity to step in. However, in doing so it would be wise to look at where overseas investors are putting their money as, **"at some stage the volume of investment will create a London office bubble"**. Other matters of note include the almost unprecedented polarisation of prime and secondary yields and the increasing importance of sustainability. **"The Carbon Reduction Commitment is just the start. Sustainability will influence property prices more and more"**.

Legal & General's response is 'thematic investing'. The first theme is the 'no brainers' including being overweight in London and the South East compared with the rest of the UK, overweight in prime and underweight in secondary and only buying buildings that are 'good' and/or have the potential to improve in sustainable terms. The second covers investments based on 'conviction call' assuming mild stagflation and higher real gilt yields and the third relates to hedging by being overweight in 'other' real estate, particularly with inflationary indexed rents, for example funding the hotel and conference alongside the National Football Centre in Burton-on-Trent, and

through the greater use of property derivatives and REITs. Overall the Legal & General approach is progressive – institutional investors cannot afford to stand still and just follow the IPD index.

Nick Berry of Mountgrange Investment Management explained that investors have a number of core expectations of a private equity fund manager, these include:

- Higher returns, while accepting higher risks
- Specialisation or focus
- Strong management team track record
- Co-investment /alignment of interest
- Flexibility and intensity of management
- Accountability, analysis and transparency of reporting

With investor expectations of a 20% IRR, the approach has to be proactive and hands-on rather than passive but, given the life of the fund, always with an eye on the exit.

He thought that the current investment market was sending mixed messages, which **"is good for an opportunity fund as people are taking up different positions"**. Given the low growth and low leverage environment, the market will not deliver the necessary returns on its own so investors have to work harder to achieve their goals. There is less debt finance available but it is still possible to get it. He thought it was difficult to justify the current bid levels in London. In terms of prime vs secondary, there are opportunities to improve properties substantially by say refurbishing but for much of the secondary/tertiary stock, **"it is only an opportunity if you can buy it at the right price"**.

Mountgrange's response to the current market was to split its fund investments into 'Mainstream' (50-65% of the fund), choosing 'best in class' with reduced return expectations of 15-20%, and 'Specialist' (35-50% of the fund), targeting more than 20% returns. An example of the former is the Cambridge Business Park where there is planning consent to build on adjoining land. Specialist investments have included the joint venture with Tune Hotels and the provision of mezzanine finance at Silverstone.

Institutional residential investment – opportunities and challenges

Notwithstanding the industry's representations last year in response to HM Treasury's consultation on the private rented sector, the Budget 2011 announcements came as a bit of a coup for the sector. A lower SDLT charge, potentially, from 4% to 1%, will reduce the cost on certain residential portfolio investments, with effect from Royal Assent to the Finance Act this summer, and consultation is under way on a wide range of changes to the REIT regime which, if approved, will be brought forward in Finance Act 2012. The REIT proposals include the total abolition of the 2% conversion charge, AIM listing and a new diverse ownership rule aimed at facilitating investment by institutional investors.

Collectively, these proposals, if implemented, would reduce the headline costs of investment and would get rid of the main perceived deterrents to the UK REIT regime as a viable vehicle for institutional investment in the residential sector.

Perhaps most importantly, the proposals have produced a renewed optimism and energy in the residential sector, bringing different parties to the table and stimulating discussion of potential solutions to end the current impasse.

The opportunities

Timing is good. The different opportunities for investment in the residential sector appear to be coming together. Lack of mortgage finance is leading to anticipated steady growth in demand for rental accommodation for the foreseeable future. Shortage of supply is leading to higher returns in the private rented sector. Research by Hometrack indicates, moreover, that the increased demand is not limited to the private rented sector, but will extend also to other tenures, such as affordable and social housing.

Availability of land for development to supply housing should increase as more developers, through falling sales figures and cash flow constraints, come to a suitable arrangement on pricing of land or products. They may also seek to take advantage of the potential REIT regime as an exit for their own properties.

The Government is strongly committed to planning new residential development as part of the growth solution. There are a number of ideas at large, including land auctions, which would transfer value for recycling into new infrastructure from land owners and developers to local authorities to support residential development. Supply should specifically be aided by the Government announcement on 9 June that, in addition to the current HCA activities, it would release previously developed land for 100,000 new homes by 2015 and encourage local councils to do the same. This could be particularly relevant given the large amount of suitable land currently in Government hands (see Figure 1).

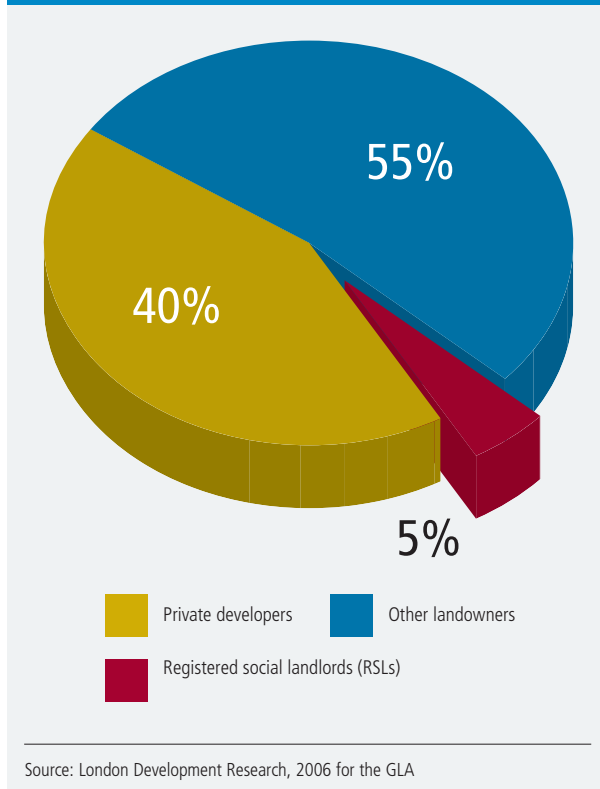
Also helpful, potentially, on the supply side, is (1) the proposal to permit the change of use of empty office space into residential property for letting, without the need for planning permission and (2) the more general idea to move to localism in the planning system to reduce the existing bureaucracy, whose faults have become all the more clear in the recessionary market.

As market and regulatory developments provide a catalyst for other changes, creative thinking is being applied to the sort of products that can help bring about the new supply. The need for registered providers (and others) to find alternative funding to make up for the reduction in the Government grant is, for example, giving rise to other opportunities. The affordable rent product (where registered providers will be allowed to charge tenants up to 80% of market rent, provided they commit to carry out new housing development) is just one of these. The returns from this could be packaged up in a way attractive to investors. The new regulatory climate under Solvency II for insurance companies is already changing investment behaviour and providing different opportunities for those entities and others to step into the funding breach, with various types of corporate lending and bond type structures, as well as land-based solutions and equity type investments. The new extended category of who can be a registered provider may well also provide new investors who can take advantage of the benefits that the new regime can offer.



Cathryn Vanderspar,
Partner,
Berwin
Leighton
Paisner LLP

Figure 1: Planning pipeline in London by proportion of private units, 2006

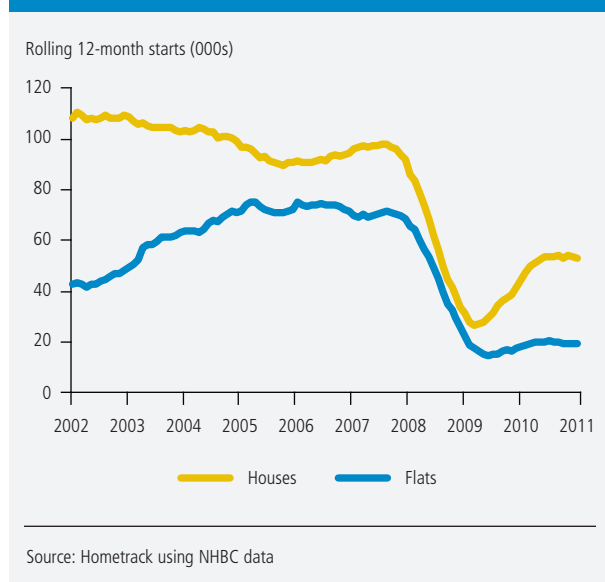


The potential for a REIT (in its proposed form), being a UK-managed, tax efficient, liquid and regulated, income yielding entity, as the vehicle through which to bring more institutional money into the various parts of the sector should not be overlooked. While the REIT is not, of course, the only potential

efficient vehicle for such investment, it is, as a result of the Budget 2011 proposals, the one that is currently stimulating the most positive interest. One reason is that a REIT would not only give access to UK institutional money, but, as an internationally recognised brand, it should attract capital from overseas investors, who are seeking an equity investment. This could, for example, include Dutch institutions, already familiar with the residential sector as an asset class. Unlike some of its offshore alternatives, a REIT could also be very attractive to UK 'retail' investors, in particular those investing through ISAs and SIPPs, who are not otherwise able to access the sector in a simple and tax efficient manner. This greater potential investor market of the REIT should help to provide to the institutional investor enhanced liquidity and scale in the residential sector.

Interestingly and potentially importantly, the REIT is also being actively explored by developers as an exit for land that cannot be sold into the private sector. Some are already effectively operating as landlords for these properties. A REIT exit could encourage developers to supply more appropriately configured properties for the rented sector (as opposed to larger housing), which have been in short supply over recent years (see Figure 2). For registered providers, the REIT is being explored as an alternative source of new capital to carry out development, in the face of reduced grant funding. If various tenures were brought together in the REIT, this could further improve diversity for investors.

Figure 2: Housing starts by type



Not all REITs need, of course, to be new businesses with new management. There are already substantial portfolios in offshore structures, where the managers may take the opportunity to come onshore into a more operationally friendly environment. UK companies with large residential portfolios, particularly in these debt constrained times, may also find the potential to raise institutional capital and improve returns through the tax free

environment of the REIT very attractive. Singly or as joint ventures, this could all help with bringing the necessary scale to the market and potentially increasing supply. Within constraints and particularly where it has an existing portfolio, the REIT could even undertake development itself.

There are clearly opportunities for the right management too. The concern here is to address the perception of management in the residential sector as being difficult, expensive and not always good enough or, where that is not the issue, to address the fact that there is not enough good management for the scale required. In respect of the former, we are seeing management increasingly put systems in place to do the job properly and to be seen to do so. As to the scale of management available going forward, opportunities exist for harnessing, in joint venture type arrangements, the skills of the registered providers and housing associations, who have been managing major portfolios for years. No doubt, we will see the good managers developing a brand. One of the issues that will remain to be played out, particularly given the low yield environment and irrecoverable VAT issue, is whether, if the REIT becomes the vehicle of choice, management should remain external or would need to become internal.

The challenges that remain

However, despite the opportunities, the industry still needs to dispel fully the adverse perceptions and myths of the residential sector that discourage institutional investment. Challenges remain.

One of these is planning, and in particular whether it will be fast enough to help bring through the necessary and appropriate supply. Though central Government is now acting to increase the supply of housing available for rental, it remains to be seen whether the NIMBY ('not in my back yard') aspects of localism will help or hinder the position. The jury is still out on this. One concern is whether, the locals will really favour a move to more rental accommodation, either through new build or the conversion of empty offices. Certainly, it is receiving some resistance. Even where planning permission exists, there will often still need to be planning changes to cater for the changing tenure pattern. Nonetheless, the overall direction should be to ease planning constraints on the release of land for development that is demonstrably sustainable. There also remains the hot topic of whether and how planning should be used as a tool to help bolster the returns from the sector and on the impact that this could have on the various models.

Another challenge for some, particularly if they wish to enter the REIT regime, is the issue of what constitutes trading? This is particularly so where the business model has some element of planned turnaround of assets. HMRC's position is that the law has not changed in this area and it does not intend to change it. However, for those that it concerns (and it should be emphasised that it does not concern all those in the sector, by any means), there remains doubt as to what this means in practice for their particular model. To help resolve this uncertainty, the industry has asked that HMRC publish some specific guidance.

The challenge that is, however, most often cited as being the main impediment to major institutional investment in the sector, is that of the low yields from residential rental investment. These average between 3.5% and 4.5%, compared with 5.5% to 6% in the commercial sector. It can be argued that this straight comparison does not reflect the full story as it does not take account of the differing risk-return profiles. However, pending proper clarification and marketing of the position (and work is being done on this at present by the sector), the issue nonetheless remains near the top of the agenda. The alternative, total return analysis, is not assisted either at the moment by the general agreement that substantial capital growth, which has been an important factor in returns from the sector over recent years, is not likely to be a feature of the market in the short term.

While the Budget proposals will have an immediate positive impact on yield, they will still not go as far to improve the disparity between the sectors as the residential industry would like. Reduction in irrecoverable VAT on management fees and refurbishment (which has partly driven people to use offshore structures in the past), would help, but it is not on the Government's agenda at the moment.

Going forward

Proponents of the sector argue that investment in the residential sector should not be measured only on a yield basis, but that it should be taken in the round, as an income-yielding, diversified, low-risk, counter-cyclical asset. It offers a hedge against house price and wage inflation and has the potential for gains over time – just the sort of asset that an institutional investor should have in a multi-asset portfolio. It will be interesting to see, as the requirements of Solvency II bed down, whether this view is more widely taken up across the sector.

The good news for now is that the Government is listening and, more importantly, it is trying to help. The key thing is to ensure that the current momentum is not lost.

What the industry needs is for at least one large institutional investment to launch and to be successful. This more than anything would break the impasse that we appear to be in.

The time for action must be now.



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Don't wake up – the property owners' nightmare might be coming true!

Imagine a situation where circumstances beyond your control result in higher costs of ownership and occupation of your property: where your obligations under a lease and loan agreement are breached – leaving you with a property that you can't let or sell; where the value of your investment falls dramatically. An impossible Kafkaesque scenario?

Not entirely. That is what can be envisaged now that the future of funding for flood defence in the UK is uncertain, coupled with the serious possibility that flood insurance will not be available in some high risk areas after June 2013.

In the wake of the 2007 UK floods, the previous Government committed to a 10% increase in flood defence funding. However, the Comprehensive Spending Review (CSR) last October reversed this with an 8% reduction, year-on-year. In tandem with this reduction, the Department for Environment, Food and Rural Affairs (DEFRA) launched a consultation on the future administration and funding of flood defences. In terms of funding, where Government could no longer afford to meet almost all the cost, the proposal was that the private sector would have to make significant contributions.

After the 2007 floods, the Association of British Insurers (ABI) announced a revision of the Statement of Principles (SoP) – the agreement between the Government and insurers whereby flood insurance cover would be maintained. The new agreement only lasts for five years, ending in June 2013, and the Government must maintain adequate levels of flood defence investment. The new SoP only guarantees continued cover in those high-risk areas where the Environment Agency (EA) has committed to improve defences and excludes new developments.

None of the recognised property industry bodies were included in the DEFRA consultation. Fortunately, the IPF was alerted to it and made a robust response, drawing attention to the critical importance of adequate flood defences to real estate investors and occupiers. The proposals were not adequately detailed in setting out how the required additional contributions would be calculated or raised: the localism element of decision-making seemed to ignore that flooding does not respect political, geographical or national boundaries; and the focus on protecting homes overlooked the importance of maintaining business and commerce.

The results of the consultation and the basically un-amended proposals were published on 23 May. They come into effect from April 2012, although there is an acknowledgement that the first 12 months will need to be a transitional period "to allow lessons to be learned and refinements potentially made once arrangements have been tested".

So what is the likely impact on the property world? There will be uncertainty over whether any future flood defence scheme will go ahead, unless it is among the few likely to get 100% funding – primarily because it protects a deprived residential area. One of the reasons for that uncertainty is that no scheme will get its share of Government funding unless all the money has been found. The proposals do not make clear how this is to be done – that is one of the things now left to the local community to decide.

Another uncertainty is the method of deciding on what level of funding will be allocated from the flood defence 'pot'. The DEFRA report sets out the three evaluation criteria: benefits for householders; value of other benefits, to business, agriculture and national and local infrastructure; and benefits to the environment. While the benefits to a household are based on notional damage of £30,000 for every event, expected to last for 50 years, there is no clear guidance as to the way that benefits to commerce will be calculated.

These proposals appear to be very unsatisfactory from a property investment viewpoint. The level of uncertainty that they bring should be a serious factor to be taken into account in future investment and portfolio management decisions. The likely contributions, coupled with potentially higher insurance premiums, which will hit both occupiers and owners, need to be taken into account when assessing the lettable of an existing property or proposed development. The RICS is already considering the effects of sustainability on valuations and, as the IPF made clear in its response to DEFRA, there is the added complication of the uncertainty affecting the attitude of insurers towards flood risk in the future. It is difficult to see how finance can be raised if there is any doubt about the availability of flood insurance; another factor to be taken into account.

At the recent IPF sustainability and valuation seminar, Ian Mason, of Schroder Property Investment Management, commented that this was one of the most important issues on his agenda. Perhaps it should be one of yours too?



Bill Gloyn,
Partner,
European real
estate, Jardine
Lloyd Thompson
Immediate
Past-President,
City Property
Association

The Green Deal – to Band E and beyond!

In the Coalition Government's Programme published in May 2010 the 'Green Deal' was unveiled as the method by which home energy efficiency improvements would be paid for by savings from energy bills. There was a further promise 'to take measures to improve energy efficiency in business and public sector building'. The Energy Bill is currently before Parliament and contains the statutory framework for the Green Deal. It promises to have a significant impact on the energy performance of not just residential buildings but also commercial buildings – especially those in the private rented sector.

The Green Deal is designed to address the challenge of reducing CO₂ emissions from the country's building stock. 45% of the UK's total CO₂ emissions are produced by buildings (or more accurately are produced by people in buildings) – residential buildings account for 27% of the overall figure and commercial buildings account for 18% of the overall figure. Under the Climate Change Act 2008, the Government must achieve at least a 34% reduction in CO₂ emissions by 2020, against a 1990 baseline. To do this, the Committee on Climate Change advises that 3% reductions in CO₂ emissions from our buildings need to be achieved on an annual basis.

How does the Green Deal work?

The Green Deal is in essence a financing mechanism that allows consumers to pay for energy efficiency improvements to their homes, community spaces and businesses through their energy bills. The upfront cost is not met by the consumer but rather by the Green Deal 'provider'. The role of the Green Deal provider is to offer a Green Deal 'plan' to the consumer. The consumer obtains any necessary permissions and consents and then signs up to the Green Deal plan. The key features of a Green Deal plan are as follows:

- The expected financial savings must be equal to or greater than the costs attached to energy bill – the 'Golden Rule' of the Green Deal;
- Before the measures are implemented, an accredited Green Deal assessor must carry out an assessment of the property and then makes recommendations as to appropriate energy efficiency improvements;
- The recommended measures must be installed by an accredited Green Deal installer;
- For domestic premises, the Green Deal provider must comply with the terms of the Consumer Credit Act and take account of the individual circumstances of the consumer;
- The energy supplier will collect the Green Deal charge from the consumer as part of the energy bill and pass the charge on to the Green Deal provider; and
- The Green Deal charge will attach to the meter, rather than to the individual customer, and the Green Deal provider is not entitled to take a charge over the property of the consumer.

To qualify for the Green Deal, the expected savings in typical properties using a normal amount of energy must be equal to or greater than the cost of the proposed energy efficiency measures. Whilst the Green Deal plan will set out the period over which the savings are likely to be made, the savings will not be guaranteed and the consumer will have the ultimate responsibility for reducing consumption after the Green Deal measures have been undertaken. Regulations will set out the types of measures that can be included in a Green Deal, as well as establishing a Code of Practice for Green Deal participants.

What are the implications for private rented property?

When the Energy Bill was introduced last December it contained clauses that empowered the Secretary of State to pass regulations on, or after, 1 April 2015 to compel residential and commercial property private landlords to make energy efficiency improvements to their buildings. However, before such regulations were to be passed, the draft Bill originally provided that the Secretary of State should conduct a review that would consider the need for action to be taken in relation to private rented property. The findings of the review were to be published before 1 April 2014. The Government has now decided that no review is necessary and that regulations will be introduced no later than 1 April 2018. The regulations will provide that landlords of domestic and non-domestic private rented property may not let (which may be defined in the regulations to include 'continue to let') the property until such energy efficiency improvements as are provided for by the regulations have been carried out to the property. The improvements must be wholly capable of being financed by a Green Deal plan or by such other financial arrangement as the regulations provide so the Golden Rule will have to apply to the improvements.

Greg Barker, the Government Minister taking the bill through its Committee stages, explained the proposed amendments by saying that the review, "would create too much uncertainty", and that, "landlords would not be able to plan effectively for energy efficiency work". Uncertainty remains, however, as it is not clear what level of energy efficiency will have to be achieved by private rented buildings by 2018 as that is still to be prescribed by the subsequent regulations. Whilst the Bill as it stands does not stipulate that no property with an Energy Performance Certificate (EPC) rating of F or G may be privately rented as from 2018 – as was feared (and as Chris Huhne suggested at the time of the Bill's second reading on 10 May) – this is clearly the Government's intention. In fact a minimum EPC rating of E is just the beginning. In Greg Barker's words "this is a two-decade programme...we will certainly wish to go beyond [Band] E".

The Government's intentions with the Green Deal are ambitious but much of the detail remains to be unveiled in secondary legislation and it is only in that detail that we will find out how the Green Deal will work.



Chris
Brigstocke,
Partner,
Squire Sanders
Hammonds

UK Consensus Forecasts

May 2011

The Q2 2011 IPF UK Consensus Forecast shows improved expectations for 2011 over the previous quarter's figures. However, the anticipated outturn across all measures will be substantially lower than for 2010. Rental growth figures in the year ahead for all sectors have fallen marginally in the three months since the Q1 survey, although capital values have revived a little to show an average expectation for All Property of zero growth in 2011. Total return forecasts have risen in the short-term whilst, for each set of results, 2012, 2013 and five-year average projections have either weakened or, in a small number of instances, held against February's forecasts.

Key points

Latest Consensus Forecast reconfirms poor rental and capital value growth prospects.

- Rental value growth figures for 2011 have softened since the last survey and capital value growth forecasts, whilst having improved slightly in the immediate short-term, are also expected to weaken over the five years of the forecast.
- The Consensus Forecast of total return for 2011 has fallen marginally with the outlook for 2012-13 slowly climbing above the anticipated income return. City and West End of London offices continue to buck the trend with double digit returns being projected over the next two years.
- The 2011-15 average total return view has weakened again across all sectors; Central London offices are predicted to drop below 10% per annum average return, as their longer term prospects fall away from 2013 onwards.
- The general outlook for the next five years remains one of subdued performance with weak rental growth holding back All Property returns.

City and West End offices short-term prospects strengthen.

- The City and West End office sub-markets are forecast to continue their relatively strong performance in 2011 and 2012 with rental value growth projections being increased again for the coming year.
- The previous expectation for central London capital value growth to ease in 2011 has been reversed in this quarter. This sentiment continues into 2012 but reverts to the level of previous forecasts beyond this point.
- As a result, the Consensus average total returns estimate for these sub-markets in 2011 has picked up again. Whilst marked down over the later periods of the forecast, central London offices are still expected to outperform the rest of the market.

Retail sectors still vulnerable with poor 2011 projections.

- Standard shop and shopping centre rentals continue to show negative growth in 2011 but are expected to turn marginally

positive in 2012. Combined with negative capital value growth forecast in each of these sectors also over the next 12 months, total returns will drop below income yields in 2011.

- Despite recovering slightly in the later years of the survey, standard shops continue to rank below the other retail sectors.

Economic setting

Gross Domestic Product (GDP) increased by 0.5% in the first quarter of 2011, to 1.8% above the first quarter of last year, following a decrease of 0.5% in the fourth quarter of 2010 explained by the effect of the abnormal weather conditions in December¹. Forecasters are narrowing their predictions for 2011 and the Treasury consensus forecast of GDP for the year has fallen from 1.8% in February to 1.6% in May², meanwhile the OECD has cut its UK growth forecast to 1.4% and called on the Bank of England (BoE) to increase interest rates to get inflation under control. The Treasury believes continued recovery in the world economy will support domestic growth, in combination with the dual stimuli of monetary policy and the current level of sterling. Official first quarter estimates reveal a 0.6% drop in household spending³, a two-year low, demonstrating the impact on demand due to the squeeze on real incomes through rising prices and wages remaining broadly static (see below).

The BoE's latest forecast³ notes that Consumer Prices Index (CPI) inflation remaining well above the 2% target with a good chance it will reach 5% later this year (largely due to higher utility bills), which is hardly surprising given the index rose to 4.5% in April. The increase was blamed on higher transport, alcohol and tobacco costs, more than offsetting a 1.3% fall in clothing and footwear prices. The rise in CPI was bigger than analysts had forecast, following a surprise fall in the index last month and is now at its highest level since October 2008. On the plus side, with no fuel duty increase, inflation was lower than it could have been and the Retail Price Index (RPI), which includes mortgage interest payments, fell slightly to 5.2% from 5.3% in March. The BoE's view is that inflation will remain above the 2% target throughout 2012.

As the dual impact of external price pressures and the increase in VAT dissipates and some downward pressure from a margin of spare capacity persists, inflation is likely to fall in the course of 2012 into 2013. Both the timing and extent of a decline in inflation remain highly uncertain however. The return of accelerating price rises after March's let-up places further pressure on the BoE to raise rates sooner rather than later. The Bank has resisted calls to raise rates on the basis that temporary, external factors, such as rising oil and food costs, are driving price rises and in the belief that raising rates would undermine the UK's fragile economic recovery. Earlier this month rates were held at 0.5% for the 26th month in a row.

The unemployment rate for the three months to March 2011 was 7.7% of the economically active population, down 0.1% on

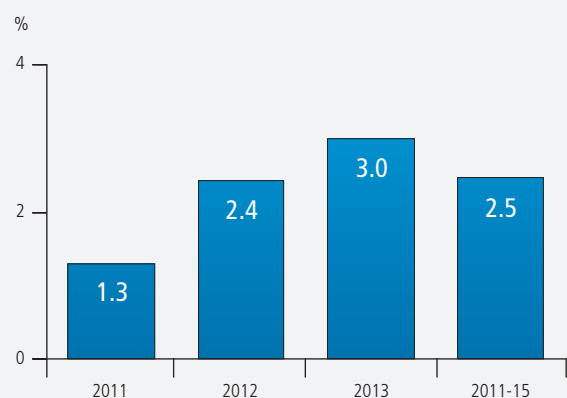
¹ ONS 25 May 2011

² HM Treasury Forecasts for the UK economy: 18 May 2011

³ Bank of England Inflation Report May 2011

the quarter¹. The total number of unemployed people fell by 36,000 to 2.46m. Within these headlines, the number of people unemployed for up to 12 months fell by 56,000 to 1.61m but those unemployed for over 12 months increased by 20,000 to 850,000, the highest figure since January 1997. The whole economy earnings annual growth rate for total pay (including bonuses) was 2.3% for the three months to March 2011, up from 2.1% in February. This disguises a slight fall in regular pay (ex bonuses) which was 2.1% for the three months to March 2011, down from 2.2% for the three months to February. With pay rises running at less than half the inflation rate, the spending power of consumers is under considerable pressure and the slump in household spending could severely restrict growth and knock the government's debt reduction plans off course.

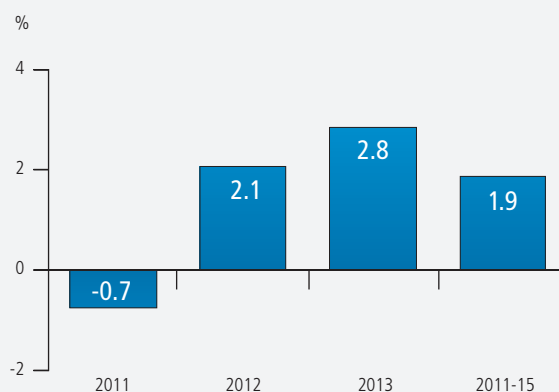
Figure 1: All Property rental value growth forecasts



The consensus All Property rental value growth forecast has weakened slightly against the previous quarter's view. Across all time periods, the outlook for rental value growth has fallen.

The pattern of previous forecasts, leading to a modest peak in 2013, continues and then falls away, as indicated by the lower five-year average projection.

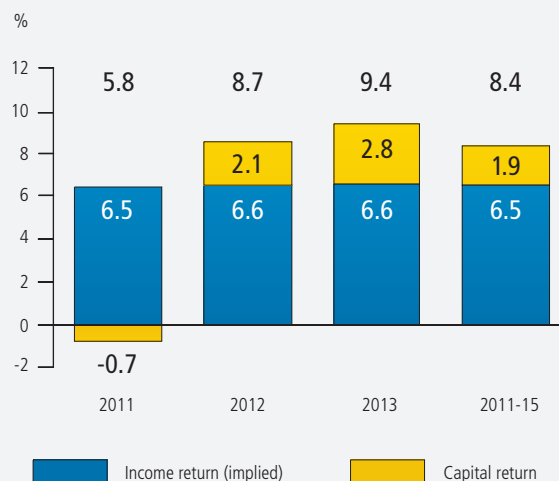
Figure 2: All Property capital value growth forecasts



The All Property capital value growth mean forecast for 2011 has improved against the last survey with the All Forecasters Consensus Mean hovering just at or below 0.0%.

Forecasts for 2012 and beyond remain positive but have once again weakened since the last report, with the 2012 forecast almost halving whilst 2013 has fallen by 50bps over the quarter. The five-year outlook has declined slightly as a result of these downward projections.

Figure 3: All Property total return forecasts



The All Property total return forecasts for 2011 has improved again over the previous quarter's consensus (from 5.8%), with expectation of negative capital value growth over the next 12 months having disappeared.

However, the outlook over the remaining periods has weakened in each instance through a combination of slightly lower income return and reduced confidence in capital appreciation.

The income return of UK property continues to favour the asset over current dividend yields of equities and bonds in a period of rising inflation.

All Property survey results by contributor type

(Forecasts in brackets are February 2011 comparisons)

Figure 4: Property advisors and research consultancies (13 contributors)

	Rental value growth %						Capital value growth %						Total return %					
	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013
Maximum	1.9	(2.5)	4.3	(4.9)	3.8	(4.7)	1.8	(3.0)	5.4	(5.2)	3.5	(5.6)	8.0	(10.0)	12.2	(12.3)	9.8	(14.0)
Minimum	-0.4	(-0.7)	1.1	(1.1)	1.8	(1.8)	-3.4	(-2.5)	-0.9	(0.5)	-0.2	(-0.5)	2.6	(4.3)	5.6	(7.0)	6.4	(6.5)
Range	2.3	(3.2)	3.2	(3.8)	2.0	(2.9)	5.2	(5.5)	6.3	(4.7)	3.7	(6.1)	5.4	(5.7)	6.6	(5.3)	3.4	(7.5)
Median	1.1	(1.2)	2.2	(2.4)	3.2	(3.4)	1.0	(0.4)	0.8	(1.8)	2.6	(3.2)	7.4	(6.7)	7.4	(8.3)	9.1	(9.6)
Mean	1.0	(1.2)	2.2	(2.5)	2.9	(3.2)	0.5	(0.2)	1.3	(2.3)	2.2	(3.1)	6.8	(6.8)	7.7	(9.0)	8.7	(9.9)

Figure 5: Fund managers (17 contributors)

	Rental value growth %						Capital value growth %						Total return %					
	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013
Maximum	2.5	(2.6)	3.2	(3.7)	4.4	(4.2)	2.6	(0.7)	5.5	(5.4)	7.1	(6.7)	9.4	(7.4)	11.6	(12.5)	13.0	(13.0)
Minimum	0.3	(0.0)	-0.8	(1.2)	0.5	(2.2)	-6.2	(-8.5)	-3.2	(-3.8)	-1.3	(-1.3)	0.1	(-1.6)	3.1	(3.3)	6.3	(6.3)
Range	2.2	(2.6)	4.0	(2.5)	3.9	(2.0)	8.8	(9.2)	8.7	(9.2)	8.4	(8.0)	9.3	(9.0)	8.5	(9.2)	6.7	(6.7)
Median	1.4	(1.2)	2.1	(2.5)	2.6	(2.7)	-0.8	(-2.2)	0.9	(1.9)	2.2	(2.9)	6.0	(5.0)	7.3	(8.5)	8.6	(9.5)
Mean	1.2	(1.2)	2.0	(2.4)	2.6	(2.8)	-0.7	(-2.4)	1.0	(1.8)	2.2	(2.6)	5.7	(4.3)	7.4	(8.6)	8.7	(9.3)

Figure 6: All forecasters (32 contributors)

	Rental value growth %						Capital value growth %						Total return %					
	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013
Maximum	2.5	(2.6)	4.3	(4.9)	4.4	(4.7)	2.6	(3.0)	5.5	(5.4)	7.1	(6.7)	9.4	(10.0)	12.2	(12.5)	13.0	(14.0)
Minimum	-0.4	(-0.7)	-0.8	(1.1)	0.5	(1.8)	-6.2	(-8.5)	-3.2	(-3.8)	-1.3	(-1.3)	0.1	(-1.6)	3.1	(3.3)	6.3	(6.3)
Range	2.9	(3.3)	5.1	(3.8)	3.9	(2.9)	8.8	(11.5)	8.7	(9.2)	8.4	(8.0)	9.3	(11.6)	9.1	(9.2)	6.7	(7.7)
Std. dev.	0.6	(0.7)	0.8	(0.9)	0.8	(0.7)	2.1	(2.4)	2.0	(2.1)	1.6	(1.7)	2.1	(2.4)	2.0	(2.1)	1.4	(1.7)
Median	1.2	(1.2)	2.1	(2.4)	2.7	(3.0)	0.4	(-0.6)	0.9	(1.9)	2.5	(2.9)	6.8	(6.4)	7.3	(8.3)	9.0	(9.5)
Mean	1.1	(1.3)	2.0	(2.4)	2.7	(3.0)	0.0	(-0.7)	1.2	(2.1)	2.3	(2.8)	6.3	(5.7)	7.6	(8.6)	8.8	(9.4)

Figure 3: Survey results by sector

	Rental value growth %				Capital value growth %				Total return %			
	2011	2012	2013	2011-15	2011	2012	2013	2011-15	2011	2012	2013	2011-15
Office	4.1	4.9	4.6	3.9	2.1	3.2	2.9	2.3	8.4	9.5	9.2	8.6
Industrial	-0.3	0.7	1.4	1.1	-1.6	0.1	1.6	0.7	5.5	7.3	9.0	8.0
Standard shops	-0.8	0.6	1.8	1.4	-1.6	0.3	1.9	1.1	4.1	6.1	7.7	6.8
Shopping centres	-1.3	0.5	1.9	1.4	-1.2	0.1	2.1	1.5	5.1	6.6	8.7	7.7
Retail warehouses	0.7	1.5	2.3	2.0	0.3	0.8	2.0	1.6	6.5	6.9	8.2	7.8
All Property	1.1	2.0	2.7	2.2	0.0	1.2	2.3	1.7	6.3	7.6	8.8	8.0

Notes

1. Figures are subject to rounding, and are forecasts of All Property or relevant segment Annual Index measures published by the Investment Property Databank. These measures relate to standing investments only, meaning that the effects of transaction activity, developments and certain active management initiatives are specifically excluded. **2.** To qualify, all forecasts were produced no more than 12 weeks prior to the survey. **3.** Maximum: The strongest growth or return forecast in the survey under each heading. **4.** Minimum: The weakest growth or return forecast in the survey under each heading. **5.** Range: The difference between the maximum and minimum figures in the survey. **6.** Median: The middle forecast when all observations are ranked in order. The average of the middle two forecasts is taken where there is an even number of observations. **7.** Mean: The arithmetic mean of all forecasts in the survey under each heading. All views carry equal weight. **8.** Standard deviation: A statistical measure of the spread of forecasts around the mean. Calculated at the 'all forecasters' level only. **9.** There were insufficient equity broker contributions to provide separate analysis. **10.** The sector figures are not analysed by contributor type; all figures are shown at the all-forecaster level. **11.** In the charts and tables, 'All Property' figures are for the full 32 contributors, while the sector forecasts are for the reduced samples (26/30) of contributors. **12.** One contributor provided a four year forecast of average returns (i.e. 2011/14).

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Property advisors (includes research consultancies): Capital Economics, CB Richard Ellis, Cluttons, Colliers International, Cushman & Wakefield, DTZ, Fletcher King, GVA, Jones Lang LaSalle, King Sturge, Paul Mitchell Real Estate Consultancy, Real Estate Forecasting Limited

Fund managers: Aberdeen Asset Management, Aviva Investors, AXA Real Estate, CBRE Investors, Cordea Savills, F&C REIT, Henderson Global Investors, HSBC Global Asset Management, ING Real Estate Investment Management, Invesco Real Estate, Invista REIM, LaSalle Investment Management, Legal & General Property, PRUPIM, RREEF, Scottish Widows Investment Partnership, Standard Life Investments

Equity Brokers: BofA Merrill Lynch

Note

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

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

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European Consensus Forecasts

May 2011

Key Points

- Forecasts at H1 2011 show diverging views across a number of office markets – a little over half of all centres show a weakening in growth prospects as against the November 2010 outlook, with the balance being static or improving slightly. Despite this increased pessimism, 20 of the 29 locations we are able to report on continue to have positive rental value growth forecast for 2011.
- Moscow, having been the foremost expected performer for 2010, maintains its strong anticipated performance in 2011 and is now ranked first, slightly ahead of London West End, at a mean growth rate of 13.2%. Together with London City, these centres are expected to continue to outperform remaining cities by a significant margin in the year ahead, all three being forecast to produce annual double digit rental growth.
- Five of the six poorest performance prospects derive from Portugal, Italy, Ireland, Greece and Spain, the so-called 'PIIGS' economies, with negative consensus rental value growth forecast of between -2.5% and -8.7%. We have insufficient returns to be able to report any specific data for Athens but those forecasting for the Greek capital anticipate a further weakening in this market.
- The consensus forecasts for 2012 have been revised downwards for six centres but improving in the remainder as well as being positive in all but two of those markets reported (Madrid and Barcelona).
- Moscow is no longer expected to outperform the two London sub-markets in 2012.
- Over three years, London West End and City and Moscow markets continue to show the strongest rental value growth respectively but City rents are not expected to grow as strongly as Stockholm and Warsaw on a five-year view. Moscow retains its premier ranking over this timeframe.
- The level of expected rental growth on balance, whilst remaining weak, does appear to be improving slightly across the majority of centres with all centres returning to positive growth over a five-year period.

Weakening outlook in 2011 across a number of markets

The most recent forecasts suggest a period of mixed fortunes across Europe. Since November 2010, just over half of the rental growth forecasts have been decreased with significant reductions in Milan and Warsaw, both of which are now expected to fall into negative growth.

The weakest expected performances are dominated by PIIGS locations, primarily Milan, Madrid, Barcelona, Dublin and Lisbon. As against the last survey, Frankfurt rents have returned to an upward trajectory, whereas Hamburg's are expected to fall further.

Overall, the forecasts for 2011 have weakened in 19 of the markets reported since the November 2010 survey, reflecting a softening of sentiment amongst forecasters for many of the European centres.

Some strong performances still expected in 2011

Against these disappointing outlooks, Moscow and the West End of London continue to show considerable improvement in their projected performance, where, together with London City, they are now forecast to deliver double digit rental growth in 2011. In the case of Moscow, growth expectations have almost doubled over the last six months, from 7.4% to 13.2%, bettering even the confidence being shown in London West End rents, now forecast to grow by an average of 13.0%.

2012 and beyond

The consensus forecasts for 2012 have been revised downwards for 19 of the cities reported, compared to 17 at November 2010, albeit the adjustments are all relatively small in absolute terms. Notably, these downward shifts exclude both London markets, although expectations for Moscow have tempered somewhat, following substantial growth expectations in 2011.

In absolute terms, only two centres, Madrid and Barcelona, are expected to see negative rental growth in 2012. The substantial majority of markets (17) are forecast to grow by a modest 3% or less, with only the London West End market expected to reach double digits (at 10.6%, an improvement over the November 2010 average forecast of 8.2%). London City also appears to hold up well with the projected increase rising by 8.6% (8.3% at November).

The three-year forecasts continue to reflect the weakness of the Spanish, Italian, Irish and Portuguese markets. Moscow and London maintain their top ranking positions, with an average of between 9.5% (London West End) and 8.1% (Moscow) average growth over this period.

The five-year outlook appears more positive with all centres reported returning to positive growth over this timeframe; only Lisbon is projected to show growth below 1%. Joining the two London sub-markets and Moscow as top performance prospects are Stockholm and Warsaw, the latter suggesting a significant bounce back following a currently anticipated fall in rents during 2011. Rents in these top five centres are expected to grow at an average rate in excess of 5% for the period 2011-15.

Summary

Current growth expectations for the next three years show a tighter grouping of forecasts by 2013. By the end of this period,

rental growth across the 28 cities is expected to lie within a range of 1.8% to 5.5%, compared to -8.7% to 13.2% for the current year.

The May 2011 IPF European Consensus Forecasts suggests contrasting views on the performance prospects across many centres. They are consistent, however, in identifying relatively slow and weak recovery in rental value growth in the majority of the cities covered. The strong performance of certain key financial centres will decline but still offer above average growth against other locations.

European office market prime rent forecasts, May 2011

	Year rental growth forecast % pa			3-year forecast 2011-13 % pa	5-year forecast 2011-15 % pa
	2011	2012	2013		
Vienna	0.4	1.7	2.1	1.4	1.9
Brussels	2.6	2.9	2.9	2.8	2.5
Prague	1.1	2.8	3.6	2.5	2.9
Copenhagen	1.4	2.0	2.3	1.9	2.2
Helsinki	4.5	2.4	2.8	3.2	2.5
Lyon	1.5	2.1	2.6	2.1	4.9
Paris CBD	-0.1	4.7	5.5	3.3	4.0
Paris la Defense	2.3	3.4	4.4	3.4	3.4
Berlin	3.6	2.8	2.1	2.8	3.3
Frankfurt	2.3	3.7	4.5	3.5	2.9
Hamburg	-3.3	1.8	3.4	0.6	1.5
Munich	2.6	3.1	3.7	3.1	2.8
Athens	na	na	na	na	na
Budapest	1.4	3.1	3.6	2.7	2.3
Dublin	-4.3	1.2	2.7	-0.2	1.7
Milan	-8.7	1.3	2.1	-1.9	2.5
Rome	1.1	1.7	2.3	1.7	2.1
Luxembourg	-1.0	1.2	2.5	0.9	2.2
Amsterdam	0.6	1.4	1.8	1.3	1.9
Oslo	6.6	2.5	3.4	4.1	3.4
Warsaw	-1.7	4.6	2.6	1.8	6.3
Lisbon	-2.5	0.3	1.9	-0.1	0.9
Moscow	13.2	6.4	4.9	8.1	6.8
Madrid	-4.3	-0.7	3.5	-0.6	1.9
Barcelona	-4.4	-0.1	3.0	-0.5	1.8
Stockholm	4.9	4.2	3.8	4.3	3.8
Zurich	1.2	1.6	2.9	1.9	2.5
London City	10.4	8.6	5.5	8.1	5.3
London West End	13.0	10.6	4.9	9.5	6.7
Manchester	0.8	3.0	2.3	2.0	2.3

Forecast Contributors: IPF would like to thank the following organisations for contributing data to the May 2011 European Consensus Forecasts: Aberdeen Property Investors, Alecta, Aviva Fund Management, Cushman & Wakefield, DTZ, Grosvenor, Invesco, PMRECON, PPR, Schroders, Standard Life Investments, SWIP.

Notes

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

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

The Data

This latest survey collected prime office rental forecasts for 30 centres for the calendar years 2011, 2012 and 2013. We request a three-year average forecast for 2011-13 if individual years are not available, and a five-year average for 2011-2015. The survey requested both the percentage annual rental growth rates and also year-end rent levels. The growth forecasts provided by each organisation have been analysed to provide average ('consensus') figures for each market. Figures are only reported for cities where a minimum of 4 contributions were received.

The definition of market rent used in the survey is 'achievable prime rental values for city centre offices, based on buildings of representative size with representative lease terms for modern structures in the best location.' Prime in this case does not mean headline rents taken from individual buildings, but rather rental levels based on market evidence, which can be replicated. All figures included in the survey are required to have been generated by formal forecasting models. The report is based on contributions from 14 different organisations.

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

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

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

Disclaimer

The IPF Survey of Independent Forecasts for European Prime Office Rents is for information purposes only. The information therein is believed to be correct, but cannot be guaranteed, and the opinions expressed in it constitute our judgment as of the date of publication but are subject to change. Reliance should not be placed on the information and opinions set out therein for the purposes of any particular transaction or advice. The IPF cannot accept any liability arising from any use of the publication.

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IPF Survey of IFAs

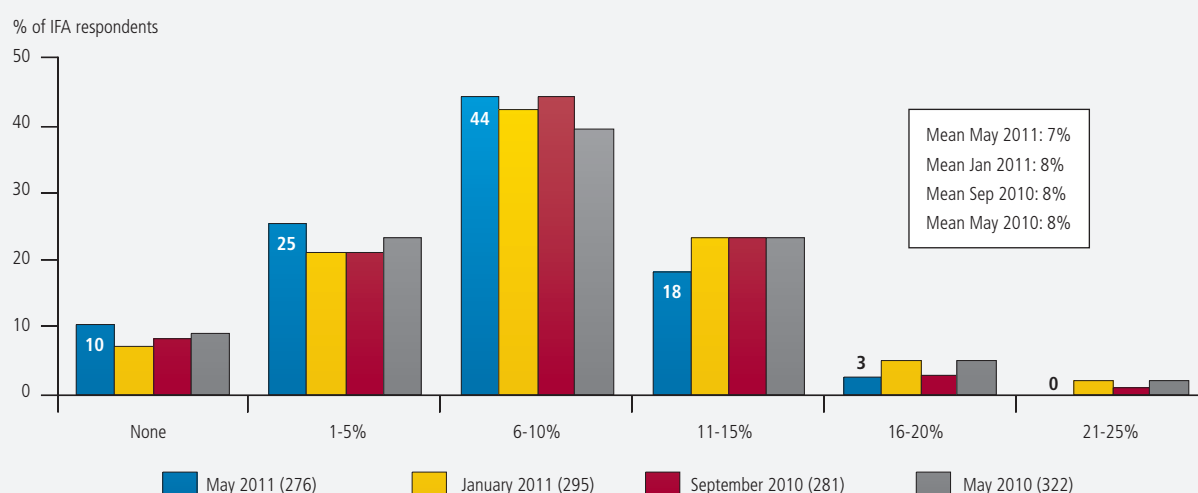
June 2011

Latest IPF survey of IFAs shows little change in sentiment towards property.

The second wave of the IPF Survey of IFAs for 2011 indicates there has been little change in sentiment towards real estate investment over the last four months. Whilst the average recommended allocation to property has fallen from 8% to 7%, it is too early to determine whether this denotes the start of any trend. However, the decline in the number of IFAs recommending a nil exposure to property has been reversed in this survey, rising from 7% to 10%.

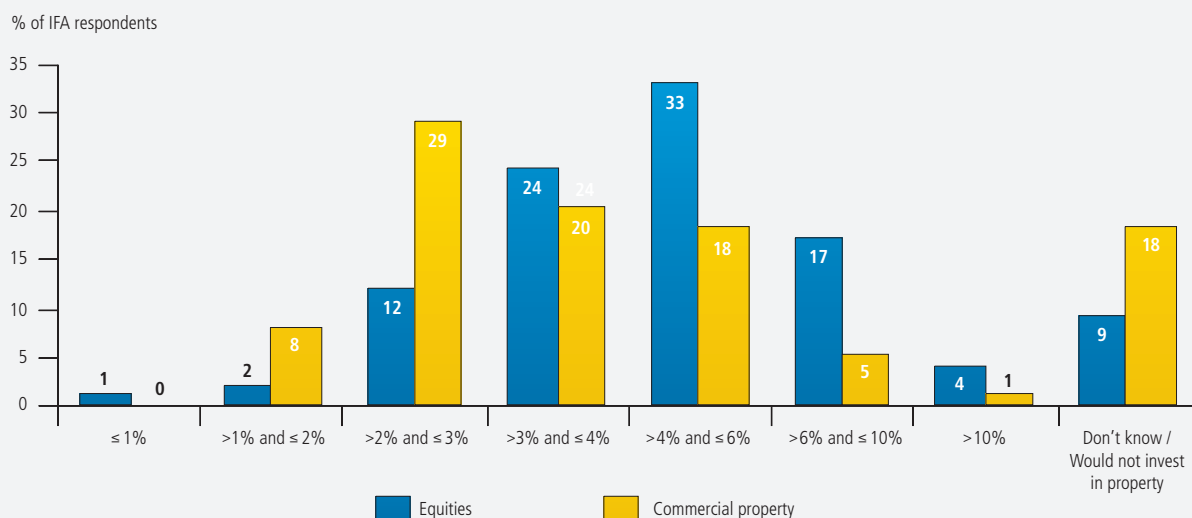
Conversely, there has been a significant increase over the past year in the number of IFAs who have not changed their recommendation to the asset class in the preceding period (51% in May 2010 versus 67% in May 2011). This is presumably a consequence of the fall in the number of advisors recommending that their clients reduce their property holdings (12% in total, as against 17% in the previous survey). Those recommending their clients to increase their exposure (either a little or significantly) has remained relatively stable, at 20%.

Figure 1: Percentage of a client's portfolio IFAs would typically recommend being allocated to property investment



Source: IPF Survey of IFAs, June 2011

Figure 2: Mean additional return for equities over commercial property investments



Source: IPF Survey of IFAs, June 2011

Although IFAs generally appear positive towards future returns from property, with the majority expecting average annual returns to exceed 6% over the next five years, this is not reflected in the shorter term outlook, with more than 20% expecting zero or negative returns over the next 12 months. The number considering their clients to be over-exposed to the asset class continues to exceed those that think their clients should increase their investment (45% as against 23%).

Commercial property in the context of other assets

The mean return in excess of the risk-free rate required for equities by clients of this respondent group fell slightly to 4.9% (previously 5.1%) with the same measure for commercial property remaining 3.6%, thus slightly narrowing the margin between the two asset classes. The majority of IFAs require risk-adjusted returns to lie between 2% and 6% for commercial real estate, somewhat less demanding than for equities (see Figure 2).

Investment characteristics

The most important investment characteristics of commercial property for the IFAs remain stable income flow, diversification from equities and bonds and capital growth in that order, with regular stable income overtaking its value as a diversifier from the previous survey results. Liquidity continues to rank as the least important feature of the seven categories listed, with tax efficiency and inflation hedging characteristics also low in importance.

Sector demand

A high level of respondents did not state a preference for types of property (49% 'Don't know') or declined those sectors identified (28% 'None of these'). Of those IFAs that did select one or more property types, offices, favoured by 16% this time last year, continues to weaken to a level comparable to the demand expected for residential and healthcare property (around 10%), although the current difficulties being experienced by certain nursing home operators may cool interest in this sector.

Conclusion

IFAs recognise that total returns are not going to match the levels of 2010, albeit the higher income yield and lower average threshold rate of return than for equities commend property to investors. However, advisors are displaying uncertainty as to where their clients should invest their money with no one sector standing out currently, although the UK remains the most favoured destination.

Notes: The IPF Survey of IFAs is carried out three times a year by NMG Financial Services Consulting as part of a wider IFA Census. The sample is drawn from IFAs who conduct at least 25% of their business in savings, investment and pensions.

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Forum activities and announcements

IPF Chairman

Phil Clark, Head of Property at AEGON Asset Management has taken over from John Gellatly as Chairman of the Investment Property Forum. Amanda Howard of Nabarro is the new Vice Chairman.



IPF Management Board

The Management Board has been bolstered by the welcome addition of Susan Geddes of Santander and Paul Clark of PMA.

Midlands Lunch

The Midlands Annual Lunch took place at the Hyatt Regency in Birmingham on 7 May. Almost 200 guests attended. Following the lunch, David Allen talked to Anthony Glossop, recently-retired Chairman of St Modwen Properties, in a Q&A session. The Lunch was sponsored by Barclays Corporate, DLA Piper and Lloyds Bank Corporate Markets.



Investment Network Event

The first Investment Network event in association with Property Week, sponsored by Pramerica, took place on 14 June at Hush. 100 people turned up to hear Nick Leslau's thoughts on the current market. The next by-invitation event will take place in the autumn – date to be confirmed.



8th Annual Property Investment Conference in Scotland

The 8th Annual Property Investment Conference in Scotland was held on 3 June at the Radisson Blu hotel in Glasgow. Entitled 'Property by nature, property by investor', the conference attracted over 100 delegates. We are grateful to Miller Developments and Dundas & Wilson for their support.

A report from the conference is included on pages 22-23.

Next Generation

The IPF is setting up a Next Generation Group, focused on members with 5-10 years industry experience. The launch event is scheduled for 16 November – full details to follow shortly.

Annual Dinner

The IPF Annual Dinner took place at the Grosvenor House on 22 June. Over 900 filled the Great Room and after dinner were entertained by the comedian Sean Lock.

The event was sponsored by Knight Frank, Langham Hall, Valad and CoStar.





Investment
Property Forum

Midlands Dinner 2011

Thursday, 6 October

**International Convention Centre,
Broad Street, Birmingham**

18:30 Pre-dinner drinks **19:30** Dinner | **Black Tie**

Guest Speaker: Geoff Miller

National Selector, ECB

As a cricketer, he scored an impressive 14,000 runs and took over 1,000 first class wickets. Geoff captained Derbyshire, played for Essex and vice-captained England. He is now one of the funniest speakers on the circuit – engaging even those with no interest in cricket!

Ticket price: £90 excluding VAT

£108.00 inclusive of VAT @ 20% per person
(excluding wine and liqueurs).

For more information or to book,
contact Barbara Hobbs on 020 7194 7920
or email bhobbs@ipf.org.uk

This event is kindly sponsored by:

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