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FOCUS

Property: 'Where are we now?'

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In this issue:

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From the editor

Sue Forster, Executive Director, IPF

This edition of **Investment Property Focus** features an overview of the prospective volume and type of senior debt lending that may be available during 2013. The **IPF's Research Director**, **Pam Craddock**, found, in undertaking the annual Property Lending Forum survey, that many more lenders are more active than they were last year and the diversity of these lenders is, in the words of one experienced banker, 'surprising'.

John Forbes of **PWC** highlights the increasing importance of investment opportunities and capital from the young, urban middle class in developing Asia. They will need to invest and provide for their old age, creating a demand for new investment products, leading to a dramatic change in the life insurance and pensions industry. The real estate industry will also have to adapt in the next decade to match the changing business models of those who provide for old age.

More immediately, **Graeme Rutter** of **Schroders** considers the appropriateness of a performance benchmark comprising other property funds and the focus on recent history rather than the longer term in assessing the performance of individual funds. He suggests that investors should look at the performance of their property investments over longer periods – a minimum of five-year rolling periods – to avoid short-term influenced behaviours.

Given the increasing institutional interest in the residential sector, as demonstrated by the recent PRUPIM acquisition, I took the opportunity to ask **Marcus Cieleback** of **PATRIZIA Immobilien AG** and **Michiel Dubois** of **Bouwfunds Real Estate Investment Management** about their experience of investing in the residential markets in Germany and the Netherlands. Both highlight the importance of political certainty for stability in the sector – a view that also has resonance in the UK.

George Matysiak of **Master Management Group**, Warsaw and **Robert Fourt** of **Gerald Eve** consider the impact of property holding periods on property performance. They conclude, perhaps not surprisingly, that over the longer term individual property risk tends to converge to that of the underlying market risk, and returns converge towards average market performance.

Louise Ellison of **PRUPIM** and **Gerry Blundell**, **Consultant**, take the recent research commissioned by the IPF Research Programme, **The Cost of Improving Energy Efficiency in Existing Commercial Buildings** (covered in the July 2012 edition of Focus), a step further by looking at the financial returns for each upgrade and then estimating an external rate of return arising from the resultant CO_2 savings. **Tatiana Bosteels** of **Hermes Real Estate** details the actions being taken by responsible European real estate practitioners, and the investment tools and methods available to them, in the light of ever stricter environmental regulation.

Summaries of the **February IFA survey** and **UK consensus forecast** are also included, together with an overview of the **IPF membership survey** results.

IPF activities and announcements can be found on pages 28-29.

Paul McNamara, **Consultant** and **IPF Research Director**, **Pam Craddock**, outline the discussion points in the IPF Short Paper, **Constructing an Effective Rental Value Index**, and make mention of the subsequent industry consultation undertaken by the Forum. We will report further in subsequent editions of Focus.

We have included details of the **Nick Tyrrell Memorial Prize** again, not least because the deadline (31 May) for entries for the 2013 Prize is fast approaching.

Lastly, may I remind you to book for the Annual Dinner, which marks the start of the **IPF's 25th Anniversary** – more on that topic in the July 2013 edition. If there are any other topics you would like to see covered then, please let me know.

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A spotlight on the Dutch and German rented residential sectors

At the IPF seminar on 'Residential Investment in Continental Europe', held in London in November 2012, Marcus Cieleback, PATRIZIA Immobilien AG and Michiel Dubois of Bouwfonds REIM talked about their first-hand experience of the markets in Germany and the Netherlands.

Subsequently, they spoke to Sue Forster about the general size and structure of the rented residential sector in the respective jurisdictions covered by their organisations. This discussion is outlined below.

Sue Forster (SF): How large is the rented residential sector in your respective domestic markets and how much of this is held by institutional investors?

Marcus Cieleback (MC): In Germany, rented property accounts for 55% of the overall stock, of which only 25-30% is in institutional hands.

For the last 20-25 years, the rental sector has been dominated by private investors. Prior to that, the insurance companies had a large proportion of their holdings in residential but they sold a lot in the 1960s and 1970s, due to a combination of increasing political interest in the sector and property management being far more intensive than that required for commercial property.

There is no one dominant player in the German market, particularly as organisations tend to specialise in particular certain regions or sub-markets. Investors with large residential holdings include GAGFAH, Deutsche Wohnen, GSW Immobilien and PATRIZIA Immobilien.

Michiel Dubois (MD): 40% of the total housing stock in the Netherlands is rented. Of this, the housing associations account for 82%, private investors 13% and institutional investors only 5% (equivalent to 132,000 dwellings).

Institutions used to hold nearer 10% but they have been selling them to private individuals, who have been benefitting from fairly-relaxed mortgage regulation and low interest rates. The main driver for these sales was the large differential in price achievable for property with vacant possession compared with rented. This sell-off is unlikely to continue to any significant extent as potential purchasers have been hit by the recent introduction of tighter mortgage regulation and falling house prices, due in part to loss of consumer confidence.

There has been a considerable number of mergers in the housing association sector in order to take advantage of economies of scale – in the past, there were around 800 but this has now halved and is likely to decrease even further. Coupled with this, the associations are also reducing their holdings, triggered by a less favourable funding and taxation regime. They are selling to institutional investors, who see residential as one of the few sectors to offer growth prospects currently – the demand for housing is still growing because of more and more one-person households.

Marcus Cieleback, PATRIZIA Immobilien AG

SF: How much do your organisations have invested in the rented residential sector and what do you consider to be the attractions of the sector as an investment?

MC: PATRIZIA has €7.5bn under management, of which 40-45% is in residential and 90% of this is in Germany.

The main investment attractions of the sector are security and stable cash flow. Risk of loss of cash flow is very low due to high granularity and, as housing is a basic need, rents move smoothly and are less cyclical. With a good asset manager, you can get generate a similar income return to that of commercial property.

Michiel Dubois, Bouwfonds REIM

MD: Bouwfonds REIM has approximately €5.5bn under management, with €1.3bn (25%) in residential. This is invested predominantly in Germany and the Netherlands, followed by France and the Nordics.

As regards the attractions of residential property as an investment, I agree with MC's opinion and would add that residential offers the best diversification in real estate – retail and office investments are often affected by market cycles at the same time, while residential markets differ from city to city.

SF: So are there particular cities/towns where your organisation's holdings are concentrated?

MC: All cities that offer potential growth in rental values and demand. We look very closely at the demand and supply of accommodation in each market.

MD: I agree with MC. Our approach is research driven; rental growth is fuelled by demographic/household growth or economic growth. We focus on large cities and regional 'champions'.

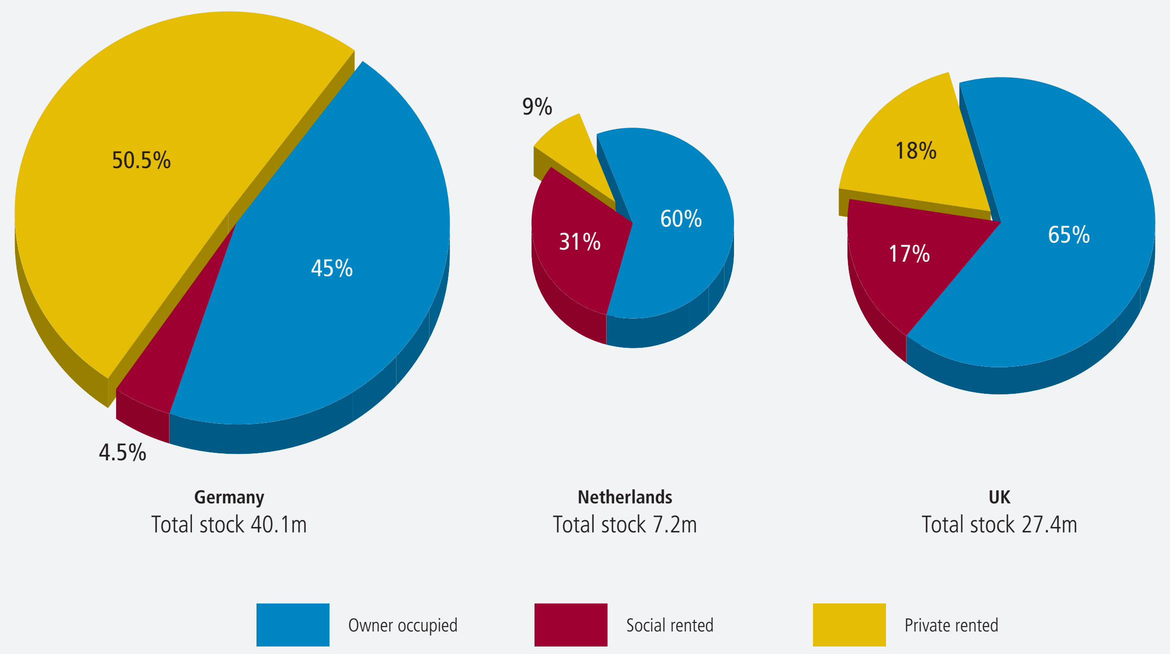
Timing and pricing is also very important – we used to buy a lot in Germany but with prices falling in the Netherlands, we have now shifted our strategy to take advantage of this.

SF: How do you hold your residential investments?

MC: We have joint ventures and operate funds – some are on our balance sheet and the rest we manage for others.

MD: We don't have any joint ventures but operate through non-listed funds, and separate accounts – co-investing where requested.

Figure 1: Comparison of the ownership structure in the Dutch, German and UK housing markets



Sources: Housing Statistics in the European Union, CECODHAS; ABF Research, Syswov 2012; DCLG Live Table 101

SF: What about residential investment outside your home market, now and in the future?

MC: We are looking to increase our current holdings in Sweden, Denmark and Finland. We are also looking at Ireland, Norway, France and the Netherlands – the last is of interest because of recent legal changes.

The UK is interesting and we are thinking about involvement but are not sure whether the investors will be there. UK investors sold out when the regulatory environment got too difficult and it is hard at present for outsiders to get a handle on the market and determine how to gain economics of scale.

Generally we are looking to increase our holdings in attractive locations, as outlined earlier, where there is strong investor interest.

MD: Our approach is to view Europe as being the domestic market so investment is not about countries but rather regions within them.

We are not active in the UK yet but it is a large and transparent market and so is on our radar. Also other regions are on our radar, like Dublin and Warchau.

SF: What impact does regulation of the residential rented sectors in different jurisdictions have on your investment decisions?

MC: We take account of the local regulations in our investment modelling, e.g. Finland has a less regulated market than Sweden so rental growth has been much higher but this is reflected into the price.

MD: Regulation and politics are important to consider in any market. It's all about stability of returns and predictability – rent control is not an issue providing that it has been priced in at the time of purchase.

SF: Are there any proposals to change the regulatory environment for residential property in your domestic market?

MC: As from late 2013, rental increases in Germany will be limited to a maximum of 15% over three years, compared with the current limit of 20%. This is politically-motivated – in an election year, it plays well to voters in metropolitan areas.

There is also little political support for new housing construction so there will be a reduction in future supply.

MD: There are many proposed changes, driven by the government's need to generate or save money. The two principal initiatives at present are to: (a) reduce the tax relief on mortgage interest – this will be done gradually as house prices are currently falling; and (b) to encourage richer tenants to vacate rent-controlled housing by increasing their rents more rapidly, thereby releasing units for those in need.

SF: Is land zoned in German and/or Dutch city plans for rented housing or just for residential generally and do your organisations build-to-let?

MC: City planning allows for residential use and then the building permit determines the type of housing you build, e.g. you may have to include low-cost housing.

We build some housing to rent – it is market and location dependent. We also build to sell.

MD: In the Netherlands, plans are quite detailed. Municipalities like mixed developments – social rental housing with owner occupation for example. However, they do take into account the harsh realities of the current market. Developers required to provide social housing may also do a trade with a housing association.

We generally buy existing buildings that are already tenanted but we do have development roots through our sister company and we also buy empty properties from developers.

SF: If, and when, you sell any residential investments, do you sell with vacant possession or with the tenants in place?

MC: It depends on the individual building and market. Sometimes we sell with vacant possession and sometimes there are investors who will pay more than the vacant possession value for a tenanted building.

MD: It depends on the market. We used to achieve large premiums for selling with vacant possession but, with prices in the owner occupier market falling, there is less difference at present.

SF: On what basis do you value residential property in your investment portfolio?

MC: They are valued on a DCF basis using market rents and making deductions for untenanted units.

MD: Our external appraisers also value the cash flow using DCF – discounting for vacant units. We only consider vacant possession value if the property is to be sold in the very near future.

SF: Looking at the landlord and tenant relationship in more detail:

a) What rights do tenants have to security of tenure?

MC: In Germany, the lease is unlimited as long as the tenant pays the rent and the owner does not seek vacant possession through the prescribed legal means.

MD: Tenants are well protected in the Netherlands so landlords are generally unable to terminate the lease. For investors, the key is to have a large portfolio as based on historical data most houses change hands on average every 10 years.

b) What rent regulation is there?

MC: In Germany there are maximum rents permissible, determined by the rent table, and restrictions on rental increases, as mentioned previously.

MD: In the private rental sector, property is assessed using the dwelling valuation system (WWS), which accords points to a dwelling on the basis of the quality of the housing and the housing environment. All property with less than 140 WWS points (92% of the sector) is subject to a maximum rent, graduated by the actual number of points. The maximum annual rent increase is also set every year by the central government. Properties assessed at 140 WWS points or more are not subject to rent control.

c) What is the usual basis upon which units are let?

MC: It is usual to let unfurnished in Germany. Depending on the particular market, one may need to put in a kitchen but where there is high demand this is not necessary. Carpets and wooden floors are standard but no other furnishings are required.

MD: This depends on the market and what will generate the highest rent. Fitted bathrooms and kitchens (without appliances) are standard in the Netherlands.

d) How intensive is property management?

MC: Tenants expect good building services, e.g. regular cleaning of shared staircases.

MD: Property management is intensive – a professional property manager is important. We hold regular meetings with our property managers – some every two weeks.

e) What is the difference between the gross rent received and the net operating income?

MC: Rent collection and management costs equate to around 10-15% of the gross rent. Service charge is paid separately by tenants.

MD: It is down largely to the type of property – town houses have lower maintenance costs and the tenant may do some works. High rise flats require more maintenance, e.g. the lifts but these are likely to be covered by service charges. Depending on how we account for larger amounts of expenditure, the difference between gross and net is 15-30%.

Lending Intentions Survey 2013

Pam Craddock, Research Director, IPF

A total of 64 lending organisations, comprising 43 banks, nine UK and overseas insurers and 12 other organisations, including debt funds and mezzanine finance providers, were approached to contribute to the IPF/APL Survey of Lending Intentions 2013. The results comprise the replies of 36 contributors to the survey. In addition, 13 of these contributors were interviewed to obtain more in-depth responses and views on the conditions currently affecting the real estate finance sector.

The survey was conducted between late December 2012 and early February 2013. All data was collected in confidence and aggregated for the purpose of this report so analysis at a sub-category level has been carried out only where five or more participants within each group provided responses.

The 2013 survey provides an early view of the likely quantum of senior debt available for lending in the UK over the year ahead as well as a look back at the 2012 outturn. The main findings of the survey are set out below.

Lending in 2012

The actual total lending by the 36 survey contributors in 2012 amounted to £27.6bn, which represents just over 80% of the 2011 figure. The survey did not ask contributors why they lent more or less than they had hoped but a number said in subsequent discussions that the competition to lend against their preferred category of security was a major obstacle in achieving their lending goals.

UK banks and building societies continued to be the major providers of senior debt, although almost two-thirds of their lending went to the refinancing/restructuring of existing loans. The value of loans supplied by the German banks halved (from circa £7bn in 2011). Other overseas banks registered a similar share of the market to the German banks in this year's survey.

Actual lending vs. forecast 2012

Figure 1 compares the actual amount lent in 2012 to that forecast this time last year by the 23 contributors who took part in both the 2012 and 2013 surveys. This shows that they lent £20.2bn in 2012, against a forecast of £28.9bn, a shortfall of 30%. Only two organisations substantially exceeded their 2012 targets, whilst over a third (eight) only managed to achieve 50% or less of their 2012 objective.

Lending intentions in 2013

Volume and type of finance

The 36 contributors to this year's survey indicated that up to £36.3bn of capital may be available for senior debt lending, including potentially over £10bn from lenders new to the survey. Figure 2 provides a breakdown by category of lender.

As with previous years, the traditional domestic lenders are expected to provide the majority of debt, although this may fall as a proportion of the total amount all lenders expect to provide. The balance between new business and restructuring/refinancing is more even for UK debt sources than in the last two years of the survey, reflecting a slowly improving back book.

The appetite of the German banks is slightly less than the 2012 forecast but represents an increase of 33% over what these nine organisations actually transacted in 2012. The vast majority of their lending in 2013 should be new business, with only around 6% earmarked for refinancing or early restructuring. Similarly, the eight overseas banks, of North American and European origin, expect to increase their lending by some 37% over their 2012 figures, which, if successful, would see them commit over £4bn to the UK debt market.

Insurer participants to this year's survey aspire to execute almost double their 2012 volume of lending. For Other lenders, mainly debt funds but including some mezzanine finance

Figure 1: Actual lending vs. forecast 2012

Category	Number	Forecast (£m)	Actual (£m)	Difference (£m)	Difference (%)
UK banks/building societies	6	16,465	12,028	-4,437	-27
German banks	8	5,500	3,581	-1,919	-35
Other banks (ex UK & German)	3	2,100	2,250	350	17
Insurers	5	4,260	2,322	-1,938	-45
Other lenders	1	590	42	-548	-93
All Lenders	**23**	**28,915**	**20,223**	**-8,492**	**-29**

Note: Figures are for the 23 contributors who participated in both the 2012 and 2013 surveys.

providers, they may contribute around £1.8bn of debt, representing a tripling of their 2012 total if achieved. These non-traditional or 'shadow' bankers may account for up to 17% of the entire 2013 projection from this year's Lending Intentions Survey.

Lending preferences – location and type of property

This year's survey requested contributors' preferences in terms of property type and location, which are detailed in Figures 3 and 4.

Other types of property that lenders are willing to lend against comprise primarily residential (11 contributors) and hotels (10). Serviced apartments, hospitality/leisure and healthcare were also mentioned, although 13 respondents did not specify other types of property.

Given their national branch networks, it is perhaps not surprising that the majority of UK clearing banks and building society lenders do not have a stated geographic preference to their activities. The category of 'Other' captured a number of European locations and reflects where lenders are UK-based but their capital may be used to finance clients investing outside the UK.

Figure 2: Profile of Lending intentions in 2013

Category	Number of contributors	Refinancing £m	Refinancing %	Early restructuring £m	Early restructuring %	New lending £m	New lending %	Total £m	Total %
UK banks/building societies	7	6,588	34	3,306	17	9,741	50	19,636	55
German banks	9	208	4	120	2	4,750	94	5,077	14
Other banks (ex UK & German)	8	592	12	150	3	4,107	85	4,849	14
Insurers	5	658	16	81	2	3,337	82	4,076	12
Other lenders	7	525	29	100	6	1,175	65	1,800	5
Total	**36**	**8,571**	**24**	**3,757**	**11**	**23,110**	**65**	**35,439**	**100**

Note: Data based on mid-point of forecasts where range of values provided

Figure 3: Preference by type

Property type	Central London offices	Other offices	Shopping centres	Retail Warehouses	Other retail	Industrial/ Warehousing	Logistics	Other
UK banks/building societies	7	7	7	7	6	6	7	7
German banks	9	7	8	7	4	3	8	8
Other banks (ex UK & German)	8	5	6	4	1	3	5	8
Insurers	5	5	5	5	4	5	5	5
Other lenders	6	4	6	6	4	6	5	7
Total	**35**	**28**	**32**	**29**	**19**	**23**	**30**	**35**

Figure 4: Preference by location

Category	No preference	London	Major cities (incl. London)	Other	Total
UK banks/building societies	6	1	0	0	7
German banks	4	1	4	0	9
Other banks (ex UK & German)	1	3	3	1	8
Insurers	3	1	0	1	5
Other lenders	2	2	1	1	6
Total	**16**	**8**	**8**	**3**	**35**

Development finance

Development finance will be considered by up to 12 participants (half of whom are UK lenders). These organisations may be prepared to make around £4bn of project finance available for substantially pre-let/pre-sold projects. However, a small but significant number indicated they would be prepared to fund speculatively. There were insufficient responses to allow disclosure of further details but it is likely much of this finance will be for residential schemes.

Structuring

The majority of contributors (28) are willing to participate in syndicated or club deals. The maximum level of exposure varies considerably – between £25m and £250m.

From subsequent discussions, it is clear that most lenders are only prepared to participate in syndicated transactions (as opposed to club deals, where, by definition, the relationship is bilateral) if they are involved at the initial closing. Lenders are reluctant to take a position via a sell down from the originating lender/agent. On the other hand, originators may want participants to be in at closing so that they do not carry the risk of having a loan on their books that they are unable to sell down subsequently.

Lending terms

Loan-to-value ratios

Participants were asked to provide their definition of senior debt, expressed in terms of a loan-to-value (LTV) ratio. Responses varied between 55% and 75% (compared to a range of 50% and 75% in 2012). The average LTV of the 36 respondents was 66% (versus just over 60% last year), although the majority of participants (29) define senior debt at a ratio of 65% or above.

The average LTV for each sub-category of lender varies: UK banks and building societies average 67% (62% in 2012) whilst individual contributors within this group fall within a range of 60% to 70% (50% to 65% in 2012). Other banks (non-UK/German) range between 55% and 70% (previously 50% to 70%), whilst Insurers have increased their senior LTVs significantly, averaging 67% in 2013 within a range of 65% to 75% (as compared to 50% to 65% a year ago).

The German banks lie within the centre of the range of LTV ratios, although starting at 60% this year compared to 50% in 2012. The maximum LTV has fallen from 75% to 70%.

The majority of respondents (30) indicated that their maximum senior LTV ratio will vary from deal to deal, depending upon property types, location or other factors such as the asset's liquidity, debt service coverage or covenant strength.

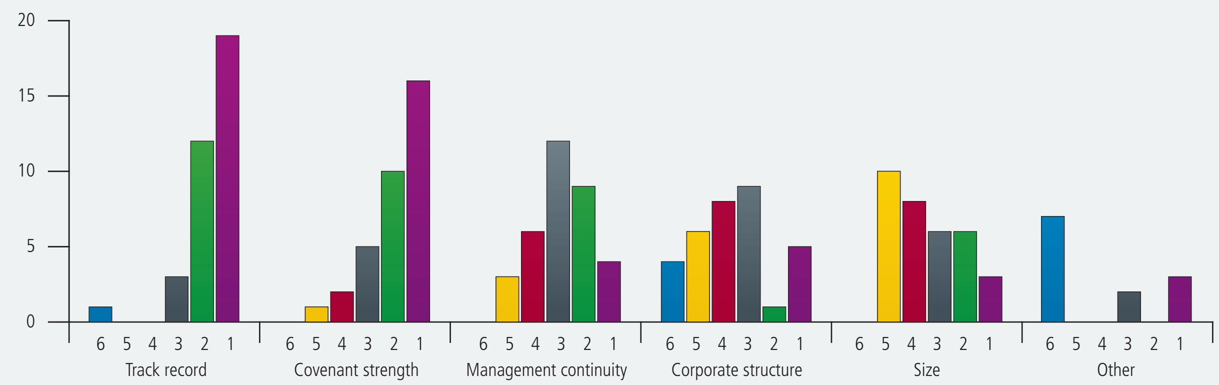
Pricing

Based on a hypothetical prime central London office asset[1], lenders were asked what margin and fees they expect to charge in 2013 for a five-year investment term loan at a senior debt loan-to-value ratio.

Few contributors were willing to answer this question in the on-line survey but subsequent discussions elicited 16 responses, which revealed a substantial variation in pricing. Adopting their own definition of senior LTV ratio, contributors ranged between 200bps and 400bps. This compares to a reported range of 225bps to 400bps in 2012 (200bps to 250bps in the 2011 survey). The average across all lenders, taking the mid-point of individual replies where a range was offered, is 288bps, compared to around 300bps last year. The averages of lower and upper estimates were 257bps and 320bps respectively.

1 Modern, A1 specification office building let to a good quality tenant on a new, 15-year institutional, FR&I lease at an open market rent with five-yearly upward only rent reviews.

Figure 5: Sponsor criteria



Note: Some respondents ranked more than one factor equal first, hence total exceeds 36

Fees

Only 11 respondents provided information regarding arrangement fees. For prime asset lending, these ranged between 65bps to 250bps, with the majority of lenders quoting 100bps. Adopting mid-point values, where respondents offered a range, the average fee is slightly over 110bps. As with the 2012 survey, fees do not necessarily appear to be a function of the level of due diligence required for a transaction.

Relationships with borrowers

Contributors were asked to identify the key factors they considered when evaluating the calibre of prospective sponsors (borrowers) and to rank these in order of priority, see Figure 5. Not surprisingly, perhaps, track record and covenant strength were identified as the primary considerations, although a small number of respondents ranked other factors than those suggested as their number one priority, including the amount of equity in the deal, whether or not the party was an existing client and the quality of the asset. As has been identified in previous surveys, for a number of major lenders securing loan sanctioning will be reliant upon being able to bring the whole business relationship to the bank, not merely the real estate debt transaction. This will clearly limit the ability of smaller borrowers to treat with these providers, whilst reinforcing existing ties for the more established property companies and REITs.

Issues for 2013

In the more in-depth interviews, lenders were invited to comment on what they consider to be the key challenges in the year ahead – three recurring topics, were identified:

Deal quality

The most often cited concern expressed was the limited volume of deals that lenders are prepared to consider, partly due to the strength of competition to lend against quality assets at the prime end of the market. This is supported by the preferred geographic locations and property types referred to in survey responses. The strategy is more prevalent amongst overseas lenders and those new to the market, being extremely risk-averse.

The situation is exacerbated by the relative dominance of sovereign wealth funds engaged in investing in prime UK real estate and characterised by cash acquisition. The number of deals requiring financing within these preferred segments has reduced substantially since the market downturn of 2008.

For the UK clearing banks, this phenomenon is perhaps not such an issue, given their comprehensive branch networks, driving greater activity at a regional level. The higher margins achievable on less popular real estate may provide this category of lender with better opportunities to deliver both the volume and level of return required.

Capital constraints

Banks are still severely constricted in terms of capital. For certain FSA-regulated UK banks the development of slotting criteria[2] is an ongoing issue, with implications for both their extant books and appetite for new lending.

The eurozone/sovereign debt crisis undoubtedly continues to cast a shadow over the European banks, as the capital adequacy requirements of Basel III will begin to apply. The profound flight to quality that this has precipitated has already led to a number of banks exiting the UK lending market (HSH Nordbank, Landesbank Berlin, Eurohypo and Society Générale to name but a few).

Conversely, the regulatory changes are less of a concern for overseas entrants to the UK market and they see this as an opportunity to gain market share, although they need to manage their foreign exchange issues.

Credit discipline

As more lenders enter the market, fears have been expressed that credit discipline may start to decline. A new entrant to the UK arena suggested that there is a lack of aptitude to price correctly and that fundamentals are beginning to be forgotten. The need to set appropriate covenants to maintain credit quality is crucial if business plans are not achieved.

By the same token, however, some originators complained of having won hard-fought deals only to find them turned down at credit as underwriting criteria have become more stringent from one deal to the next. They fear this loss of credibility could create a huge reputational problem and could risk their ability to establish and maintain business relationships.

Conclusions

How much last year's difficulty in securing volume is influencing 2013 targets is unclear but it must be a factor and will remain a challenge for as long as the market chases a restricted number of prime assets/transactions.

However, it appears that more lenders are more active than they were last year and the diversity of these lenders is, in the words of one experienced banker, "surprising". The overriding sentiment from the survey, derived from a larger and more varied group of respondents than in previous years, is cautiously up-beat. Both lenders' confidence in the real estate market and their appetite to do business are returning.

2 For a summary explanation of slotting and other regulatory issues, see Property Banking Forum: Lending Intentions Survey 2012, IPF, London 2012

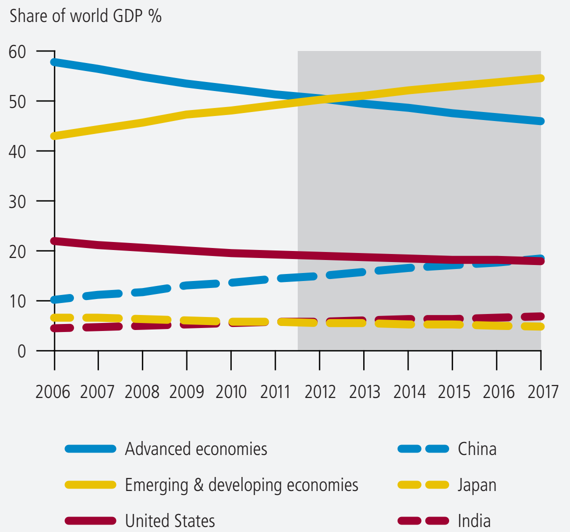
At a global tipping point

The real estate investment industry is at a tipping point in terms of its source of capital.

The shift in economic power from the more advanced economies of the G7 to the emerging and developing world has been well documented since Jim O'Neill, then the chief economist of Goldman Sachs, coined the term BRIC, in The World Needs Better Economic BRICs, a paper written in 2001 for Goldman Sachs' 'Global Economic Paper' series. What is now becoming increasingly apparent is the extent to which the years 2010 to 2015 will represent a pivotal point in this process of transition.

According to the IMF World Economic Outlook published in April of last year, developing economies are expected to have overtaken the advanced economies in share of world GDP from 2012 onwards (see Figure 1). In only a decade from 2007 to 2017, the share of world GDP of the advanced economies will have dropped from 55% to 45%, and by 2032 this will be 40%. The latest update of PwC's World in 2050, The BRICs and beyond: prospects, challenges and opportunities predicts that the seven largest emerging countries could overtake the G7 countries as early as 2017 in GDP measured under purchasing power parity terms. This rapid convergence between these two groups of economies has been accelerated by the fact that the developed countries have been much slower to recover from the recession of 2008-09, whilst the emerging economies have been relatively insulated, despite some slowdown in 2011-12.

Figure 1: The rise of emerging economies



Source: IMF World Economic Outlook, April 2012

John Forbes, PwC

Tipping points

We are at a tipping point in terms of the world's middle classes; the people with spending power. In North America and Europe, the number of people regarded as middle class is broadly static. The picture is very different in Asia and other emerging markets, as shown in Figure 2.

Figure 2: The rise of the middle class 2010 to 2030

Region	2010 m	2030 m	Growth %
Europe	668	679	1.6
Asia-Pacific	562	3,228	474.6
North America	342	322	-5.6
Central & South America	184	313	69.8
Middle East & North Africa	110	234	113.0
Sub-Saharan Africa	32	107	233.0
Total	**1,898**	**4,884**	**157.3**

Source: European Environment Agency; OECD Development Centre; PwC

We have also passed a tipping point in the process of urbanisation, where for the first time in human history more people live in towns and cities than in the countryside. According to the UN population statistics, the proportion of the world's population living in towns and cities reached 50% in 2010. In 1950 it was 29% and by 2050 it will be 69%. Over the next 30 years, approximately 1.8bn people are expected to move into cities, most of them in Asia and Africa, increasing the world's urban population to 5.6bn. By 2030, around half of the world's urban population will be living in Asia.

Finally, we are at a tipping point for ageing population. According to the latest UN population statistics, the median age for the advanced economies has just passed 40. For the first time there are now more people in the developed world over 40 than under 40. The developing world is ageing too, but will remain materially more youthful than the developed world throughout our lifetimes. The process of ageing in the developing world is bringing more people into the workforce rather than out of it.

The impact of a growing Asian middle class

A young, urban, middle class in developing Asia will become the dominant source of investment opportunity and capital. The real estate industry has already woken up to the fact that this new middle class will want to spend in shops, buy houses, use banks and other service providers, who operate from offices driving the demand from occupiers for buildings. They will also want to invest and provide for their old age, creating a demand for new investment products, new distribution channels, new sales and marketing needs. The broader life insurance and pensions industry will change dramatically over the next decade. The real estate industry needs to adapt too to match the changing business model of those who provide for old age.

According to PwC's Life insurance 2020: Competing for a future, urban populations tend to have a higher demand for insurance and other financial services. In the case of life and pensions, the factors contributing to this include greater exposure to financial products and the need for life cover when taking out a mortgage. Family sizes also tend to go down as people move off the land and into confined cities. This leaves people with fewer children to support them in their old age and therefore increases the need for pensions and life cover.

Many of the emerging economies have relatively low insurance penetration, thus representing an attractive opportunity for insurers at a time when they are facing challenges of a very mature market in the developed economies. The impact of ageing populations is putting significant pressures on traditional life insurance and pension products.

At the same time, regulatory change, particularly in the EU, is compounding the unattractiveness of products where the obligations and investment risk sit on the balance sheet of the provider. In the EU, the Solvency II will have a major impact on the way in which European life insurance companies consider real estate as an asset class. The impact will extend with the introduction of equivalent regulation for pension schemes in the form of the updated Institutions for Occupational Retirement Provisions (IORP) Directive. In mature markets, these pressures are driving a significant shift towards defined contribution retirement provision. In the newer markets, defined contribution is likely to prevail from the outset.

Real estate in a defined contribution world

A predominantly defined contribution world creates significant challenges for real estate as an asset class. In the UK, defined contribution retirement arrangements are invested largely in more liquid assets. Any real estate investment is generally in shares in REITs or open-ended funds offering daily redemptions. The report, Unlisted funds – lessons from the crisis, commissioned by AREF, explored the trade-off between liquidity, volatility, performance and risk. Providing investors with the freedom to enter funds whenever they wish is likely to be dilutive in terms of performance, as is the holding of uninvested cash in order to maximise liquidity for managing redemptions, although this liquidity may never be used. There is an interesting debate as to whether the apparently overwhelming urge of defined contribution retirement plans to invest in liquid assets is strictly necessary, with an even more interesting one as to whether this will be replicated in emerging markets.

A different approach to pension investment?

The 'anaemic' return available on low-risk, liquid investments is encouraging further the already developing trend for pension providers to look at managing return and risk over the lifetime of the policy. Investment in low-risk assets may be a necessity in the later years of a policy, but is unlikely to provide an attractive pension if held throughout. An approach of investing in higher-risk, higher-yielding, longer-term assets in the early years of a policy then moving to lower-risk investments later on provides a managed approach to risk and return over the life of the policy. In this scenario, real estate, is a more attractive asset for younger policy-holders further from their retirement date, and we might therefore expect policies held by the young, urban middle-class in developing Asia to be invested to a greater degree in more illiquid, higher-risk assets than the policies of the ageing populations of the mature markets.

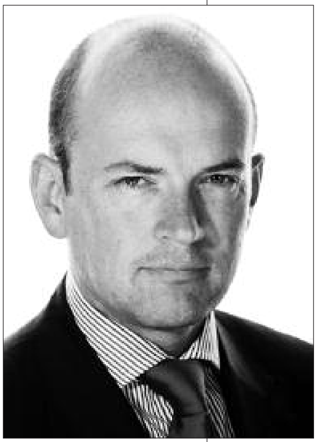
Opportunities for real estate managers

Many of the big international insurers are looking at how to better tap into these emerging pools of capital, and this should provide opportunities for real estate investment managers. Local insurance players are also gaining in strength and looking to broaden their horizons. Increasing liberalisation of insurance regulations coupled with some harmonisation, should increase the opportunities, e.g. until recently Chinese insurance companies were not able to invest in real estate as an asset class. They are now able to invest in commercial real estate domestically and internationally. Media speculation regarding a possible acquisition this month of the Lloyd's Building in London by Chinese life insurance company Ping An is the first evidence of what are likely to be many overseas forays by Chinese insurers.

As outlined above, this economic growth and demographic change in the emerging markets will create investment opportunities, but also a pool of investment capital. Exploiting either or both creates enormous challenges and potentially requires new business models. Technological change and the demands of sustainability will create challenges, but also very significant new opportunities.

All of this raises a huge question for the real estate investment management industry in the advanced economies. If the major investment opportunities and the dominant source of investment capital will increasingly be in the emerging economies, what is the role of the real estate investment management industry in the developed world, and in the UK in particular? At both the asset level and the investment product level, the opportunity is innovation. If the industry is able to create the funds and investment products to attract the new sources of capital and is also able to channel it into innovative new investment opportunities, then we can be optimistic about the long-term future of the real estate investment management industry.

The benchmarking of property fund performance – 'Under Pressure'?



Graeme Rutter, Schroder Property Investment Management Ltd

At a time that David Bowie has returned to the top of the album charts after a long absence we can perhaps take inspiration from his back catalogue to draw some conclusions about how we can best benchmark the performance of property funds when it feels as if the traditional methods of comparison are 'Under Pressure'.

'Absolute Beginners'

For many investors in property, there is a growing feeling that the UK property market has turned the corner from the crash period of 2007-09. Following the downturn, there seemed to be an acceptance that values had over-corrected, resulting in the rally of H2 2009 and 2010 and the stalemate that has followed since. Encouragingly, there are signs that the handbrake is slowly being released and the market is prepared to embrace an element of risk where over the last two years it has been obsessed with secure long income streams.

With other asset classes looking relatively expensive, this is a time when the relatively high-yield and diversification qualities offered by commercial property should be attractive. There is a challenge for property investors, however, if there are concerns over whether commonly used property benchmarks are fit for purpose.

'Golden Years'

The most commonly used benchmark for the managers of core UK property funds is a collection of comparable property vehicles that have similar styles and performance objectives. This peer group comparison has been accepted by investors and their advisors since the 'Golden Years' of the first half of the 2000s but the stresses and strains of the financial crisis have sparked a debate about the merits of this approach. The main benefit of a peer group benchmark is that it is a transparent method for the comparison of the constituent funds. It also allows managers to attribute their performance relative to benchmark and enables managers and investors to analyse funds relative to their peer group in huge detail.

'Sorrow'

There are growing concerns however that using a peer group benchmark has some significant problems, which can be summarised as follows:

- **Comparability of funds.** The commonly used benchmark index nominally includes 'balanced' funds that broadly aim to replicate the structure and performance of the UK commercial property market. Investors may assume that these funds are similar in style and substance, but there are some marked differences between funds. This includes different sector structures, exposure to leverage and average cash weightings, the proportion of indirect holdings, development projects and the underlying style of assets. Although many funds are often described as 'balanced' or 'core' (there are various definitions but in essence core describes lower risk funds with limited levels of volatility), the very wide dispersion of returns witnessed over recent years suggests that there are some equally wide discrepancies between the make-up of funds.
- **Benchmark stability.** In recent times, there have been a number of new funds entering the benchmark and several funds exiting it due to mergers, funds being wound up or funds being removed because they are considered unrepresentative of the wider peer group. The changing benchmark constituents and restatement of indices due to data amendments has resulted in unwelcome volatility and uncertainty.
- **Investor access.** The final criticism of a peer group benchmark index is that not all funds in the benchmark index are open to all investors. This may be because some funds are only available to certain types of investors (charity funds and managed pension funds for example) meaning that it is impossible for investors to replicate the benchmark.

In aggregate, these criticisms have prompted a number of investors and managers to consider the appropriateness of a performance benchmark comprising other property funds.

'Day In, Day Out'

Another failing of the current practice is that there is a huge focus on recent history rather than the longer term. Market returns are reported on a quarterly basis so there is inevitably a convergence on the near rather than the longer term. Given the high 'round trip' costs of exiting property funds and entering new ones (sometimes up to 7% of net asset value), investors should accept that they must look at the performance of their investments over longer periods.

Ideally, investors should review the success or failure of their managers over a complete property cycle, but unfortunately the duration from the peak to the trough and back again is difficult to predict. In practical terms, investors should probably look at the performance of their holdings over a minimum of five-year rolling periods to avoid short term influenced behaviours.

'Changes'

Taking on board the criticisms above, what could we as investors use for performance comparison as an alternative to the current practices? The starting point for this re-appraisal must be 'What do the investors want?'

For managers of core-style property funds, investors want to know that, as a minimum, the performance of the property assets in a fund will at least match the returns delivered by the UK property market. A good manager, with strong stock selection and asset management abilities, should be able to outperform the market average by a comfortable margin. The degree by which a fund should be expected to outperform should reflect the amount of risk a manager takes. Investors should be happy to accept a property-level return that mirrors the market, assuming that the characteristics of the portfolio are not widely different to the composition of the market. These similarities should include the look-through sector structure, the portfolio void profile, exposure to development within the portfolio and the quality of the individual assets.

Over the long term, UK commercial property has provided an average total return of 6% to 8% per annum, so it is not unreasonable for investors to assume that managers should be able to provide, say, a 7% return at a property level on average over the long term.

Investors need to accept that by investing in pooled funds they must embrace the positive and negative drivers of return that are associated with this method of gaining exposure to the property market. Putting the performance of the underlying real estate to one side, the four most significant influences on returns associated with investing through pooled fund structures are fund management fees, transaction costs, gearing and cash.

Fund management fees will dilute the net returns received by investors, as will cash holdings in most normal market conditions (when the returns from property should exceed the returns received from cash). Fund management fees will normally depress fund performance by 60bps to 100bps whilst holding cash in portfolios effectively results in a zero return for that part of the fund at present.

The impact of fund level transaction costs will vary depending on market conditions, with discounts often available in periods of market distress. In normal conditions, and unless the investor is able to trade efficiently via the secondary market, they will face an offer price to enter an open-ended fund and a bid price to exit. The total spread can be up to a 7% round trip. These transaction costs should be understood by investors.

The positive or negative impacts of gearing/leverage will depend on market conditions and the terms of the individual debt arrangements. In strong market conditions, such as those experienced in the early to mid 2000s, gearing has an almost exclusively positive impact on returns by amplifying the robust returns experienced in the property market. Unfortunately much of this excess return was lost during the credit crunch of the latter half of the 2000s as negative total returns were also compounded by gearing. From an investor's perspective, we should demand stronger returns from managers that actively employ the use of debt as part of their fund strategy. Using debt increases the volatility of fund returns and risk within portfolios, so investors should be compensated for this by experiencing stronger returns. The higher the level of gearing in the fund, the higher the out-performance target that should be set.

The same general principles should apply for specialist funds. The performance of the properties in a sector or regionally specialist fund should be measured against an appropriate sub-sector sample of UK or regional properties. Explicit adjustments should be made to reflect management fees, cash weightings and fund gearing. Given the specialist nature of the market segment (concentration risk) and management teams, often with higher fee levels to reflect this, one could argue that the performance objective for specialist funds should be considerably more demanding than for core funds.

'Where are we now?'

So, should we call time ('Ashes to Ashes' maybe?) on the traditional peer group method of assessing whether our managers have delivered? Perhaps we should just look at the long-term average returns for property adjusted for the features of the holding vehicle.

There are certainly merits in using a total return target referencing the long-term performance the property market, but also reflecting the pros and cons of investing via pooled fund structures. However there will always be a temptation to keep one eye on what the competing funds are doing. If suitable changes can be made to the way we assess whether funds have delivered there is a good chance that both managers and investors will be 'Dancing in the Streets'.

Analysing holding periods

The characteristics of real estate assets, including their illiquidity, lot size, transaction costs and overall heterogeneity, suggest that holding periods of direct real estate investment are likely to be longer than those for other asset classes. However, there is relatively little reported information on the performance of individual properties over different holding periods. An understanding of this becomes important when considering the composition of portfolio structures. Anticipated performance over different holding periods will likely shape effective portfolio management and allow investors to apply appropriate benchmark discount rates for specified holding periods.

In addition, an understanding of holding periods can assist in addressing the following:

- The factors that have conditioned holding periods for different types of property;
- Holding periods for likely 'optimal' performance;
- The potential risks of holding and trading property over different investment horizons;
- Whether it is possible to time the market and outperform benchmarks; and
- The length of time taken for a property to recover transaction costs (the vesting period).

Previous research by Gerald Eve looked at a variety of descriptive statistics on holding periods and holding period returns. The results presented in this article build on this earlier work by extending the sample to cover the period 1983-2009. Furthermore, the research looks at whether statistical differences exist in the holding periods and in holding period excess returns for different property types.

The results presented in this article are based on sold properties, that is those purchased and then sold over the period 1983-2009. This allows an analysis of performance based on transactions prices, thereby avoiding any issues associated with valuations, such as the potential for smoothing bias.

Figure 1: Distribution of held and sold property by sector 1983-2009

Sector	Total	Sold	Held
Industrial	4,236	2,543	1,693
Offices	5,785	4,236	1,549
Retail warehouses	2,012	1,221	791
Shopping centres	460	291	169
Standard retail	6,061	5,250	811
Total	**18,554**	**13,541**	**5,013**

Robert Fourt, Gerald Eve LLP

The key findings of the research are presented in several sections. The first examines the holding period profiles at both the all property and sector levels. Second, the research focuses on the investment performance of the transacted properties. Lastly, excess returns are profiled, together with a comparative assessment of excess returns at the sector level across the full sample and across various sub-periods.

Data

In accordance with Gerald Eve's specifications, IPD created a database of properties purchased and sold between 1983 and 2009.

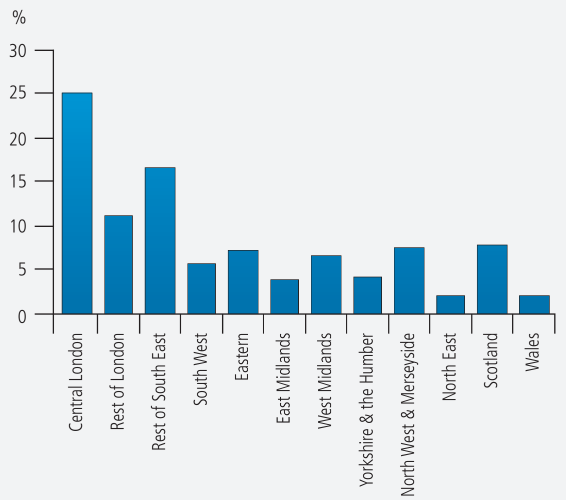
A summary of the properties in the database is shown in Figure 1.

George Matysiak, Master Management Group, Warsaw

Distributional characteristics of sold properties

Figure 2 shows the regional distribution of sales – in excess of half the sales were in London and the South East.

Figure 2: Percentage of total net sale value of all sold property by region 1983-2009



Examples of the distribution of sales by lot size are shown for retail warehouses and shopping centres in Figures 3 and 4.

Figure 3: Distribution of sold retail warehouses by lot size 1983-2009

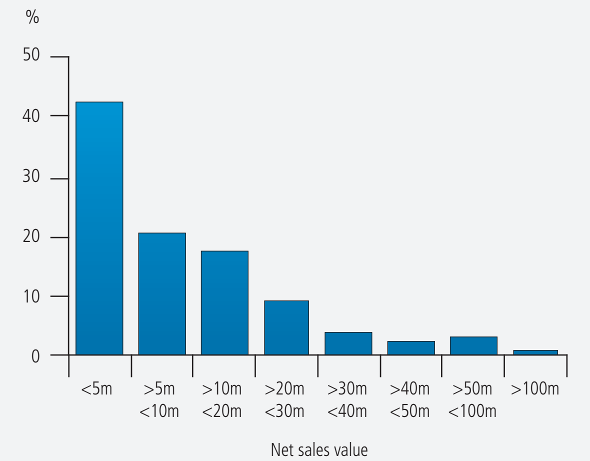
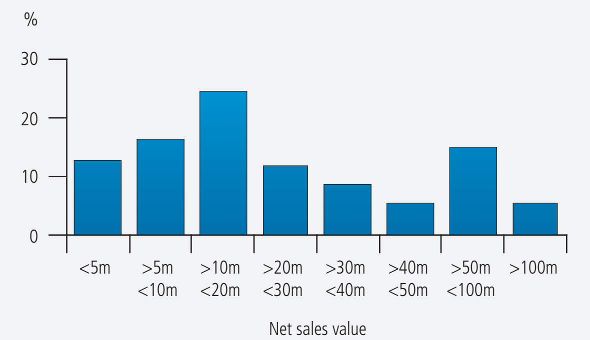
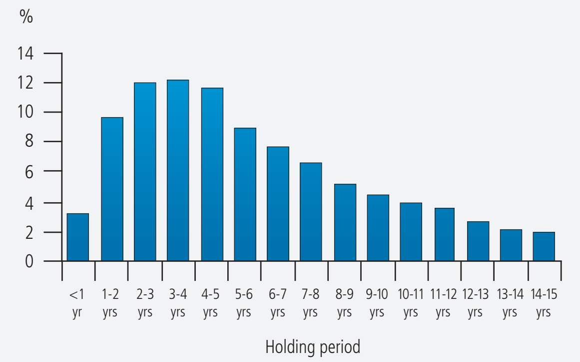


Figure 4: Distribution of shopping centres by lot size 1983-2009



The holding periods of all sold properties are summarised in Figures 5 and 6.

Figure 5: Frequency distribution of sold properties by holding period interval 1983-2009



Analysis of investment performance by holding period

Figure 7 shows the distribution of the percentile ranges of the average annualised total returns achieved over their respective holding periods across all sold properties.

There is greater variability amongst the returns of properties sold within the first three years of purchase. In fact, the standard deviation of returns of properties sold in the second year after acquisition is almost a third lower than those that are sold in the first. Similarly, the standard deviation of returns of properties sold after three years falls by a further 25% when compared to those sold after two. This highlights the fact the 'risks' associated with direct real estate investment are highest over the short term, during which there is the greatest potential to make large gains or losses. Annualised average returns have largely, but not completely, converged after five years.

Whilst Figure 7 provides interesting profiles on absolute performance, a comparison of returns against a market benchmark provides additional insights. The performance characteristics of individual properties were, therefore, analysed

Figure 6: Average holding periods 1983-2009

	Holding period			Properties sold				
	Median yrs	Mean yrs	Std dev yrs	<2 yrs %	2 <6 yrs %	6 <10yrs %	10 <15 yrs %	>15 yrs %
All Property	5.1	6.2	4.2	12.8	44.9	23.9	14.2	4.2
Industrial	4.4	5.4	3.7	15.3	49.7	21.9	11.0	2.0
Offices	5.0	5.0	4.1	12.1	46.8	23.0	14.3	3.8
Retail warehouses	4.6	5.5	3.7	14.6	48.6	24.8	9.5	2.5
Shopping centres	5.3	6.4	4.3	11.3	45.0	23.0	15.5	5.2
Standard retail	5.8	6.8	4.5	11.8	40.1	25.4	16.8	5.9

by categorising the properties as either 'winners' or 'losers' by calculating the annualised excess average return of each sold property.

For each property, its corresponding IPD sector annualised benchmark return, based on the property's holding period was calculated, which was then subtracted from the property's annualised return, thereby providing its excess return. Properties that delivered positive annual excess returns, namely those with annualised returns greater than their respective sector benchmark's annual return, were designated as 'winners' and those with negative annual excess returns as 'losers'.

Figure 8 shows the variation in average annualised excess returns for all sold properties for both winner and loser properties (here, the IPD All property annual benchmark was used as the reference benchmark).

The 'trumpet' shape in Figure 8 clearly shows the reversion of excess returns towards zero. That is, the tendency of longer held properties to perform in line with the market, for both winners and losers. This pattern is also clearly seen when the properties are analysed by sectors (refer to the full report for further details).

The reversion of the excess returns to the underlying market average as the holding period increases, suggests a reduction in the influence of unsystematic (property specific) risk over time. In other words, as the holding period extends, individual property risk tends to converge to that of the underlying market risk, and returns converge towards average market performance.

Over the period covered by the analysis (1983-2009), there was considerable cyclical variation in the commercial property market. The research therefore looked at the performance of individual properties sold in each of the following sub-periods:

- 1990 – 1992 Adverse/bear market conditions
- 1993 – 2003 Steady market conditions
- 2004 – 2006 Favourable/bull market conditions
- 2007 – 2009 Adverse/bear market conditions

Within each sub-period, there was no difference statistically in average performance across all property types between medium-term holding periods, 6-10 years, and longer-term holding periods, greater than 10 years. However, significant differences in average performance between medium-term and short-term holding periods were found.

Figure 9 shows the distribution of annualised excess returns for all offices in the bull market 2004-06.

The trend in excess returns tends towards zero and a lower variation in excess returns is evident as the holding period increases.

As a sector example, the corresponding profile for standard retail in the bear market of 2007-09 is shown in Figure 10.

Again, a profile of reducing average annual excess returns and lower variation in excess returns is seen.

Figure 7: Percentage annualised holding period returns for all sold properties 1983-2009

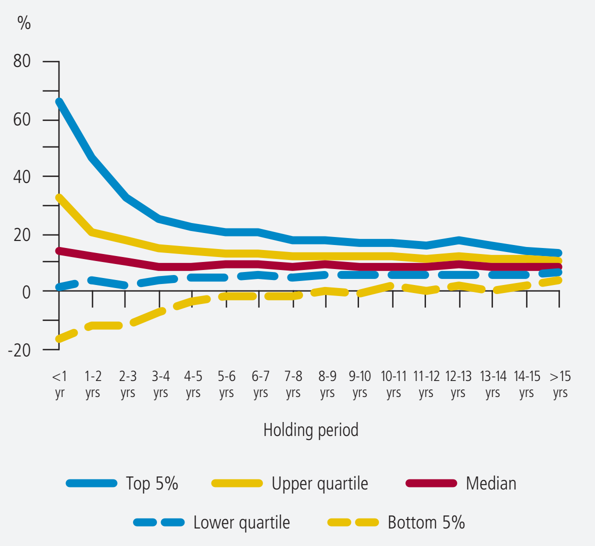


Figure 8: Average annualised excess returns of individual properties

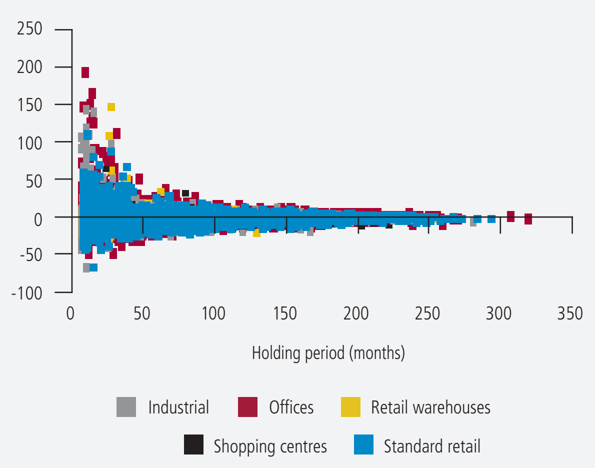


Figure 9: Percentile distribution of annualised excess winner returns – Offices 2004-06

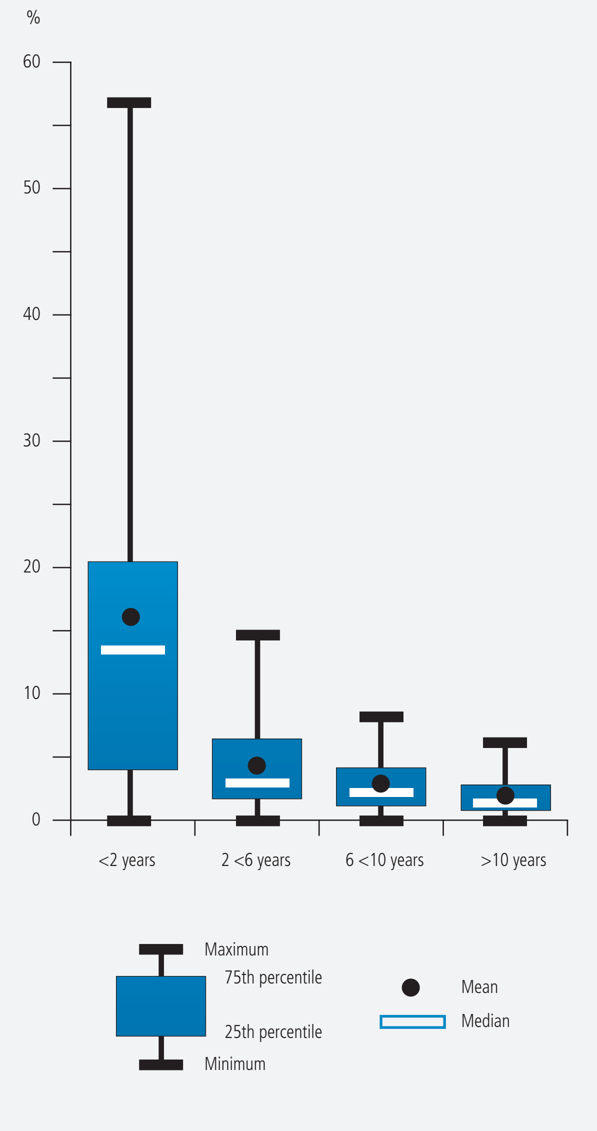
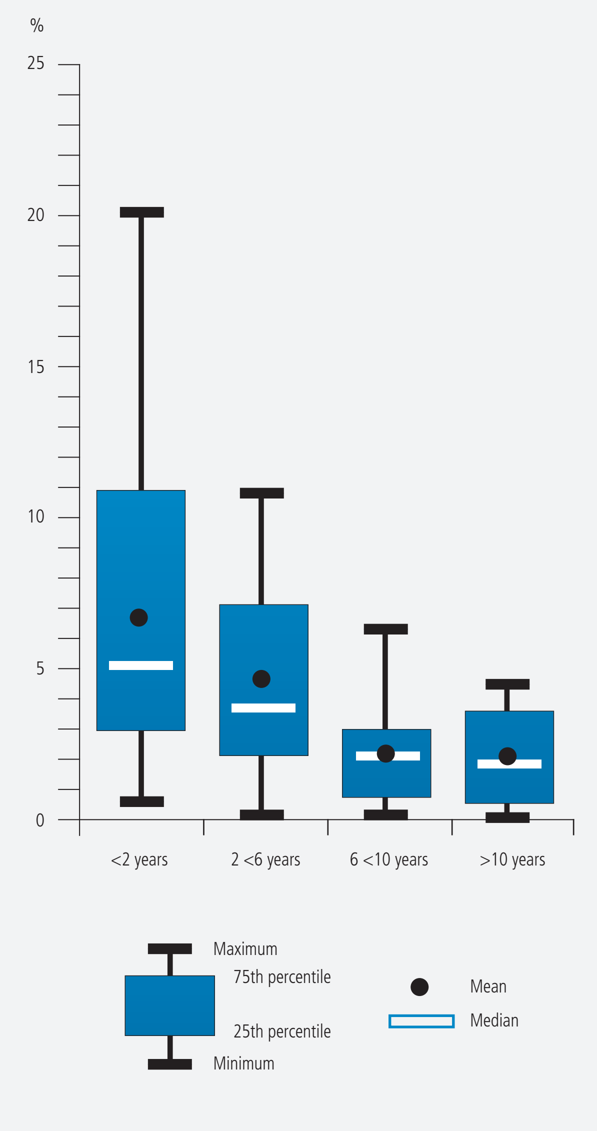


Figure 10: Percentile distribution of annualised excess winner returns – Retail 2007-09



Conclusion

Our key findings include the following:

- The distribution of holding periods is highly skewed.
- Some 58% of properties were held for a period of less than six years.
- The longer the holding period, the greater the tendency for average returns to converge towards average market returns.
- The longer the holding period, the lower the variation between excess returns of individual properties.

Accounting for carbon

Climate change and its associated regulatory policies are an emerging source of risk and, worse, uncertainty for property investors. They threaten to accelerate the rate of asset depreciation and obsolescence, lowering prospective returns. Forward-thinking investment houses have been aware of this for some time but it is not easy to work out how to respond.

Environmental regulation unknowns

The sources of this uncertainty are multi-faceted. The complexity of environmental regulation was outlined admirably by Linda Fletcher of Pinsent Masons at a recent IPF Sustainability Breakfast[1]. For example, the level at which minimum energy standards will be set is not yet clear, nor is whether a building that would meet the standard today will still pass the test after the forthcoming review of Building Regulation.

These are just some of the many 'known unknowns' that are creating uncertainty for the rational investor, thus raising risk premia for the asset class.

Focus on carbon

One consistent theme emerging through the myriad policy initiatives is a focus on monitoring and reducing carbon emissions. This seems to be the currency through which penalties and incentives will be applied. As a result, investors are beginning to monitor and manage down carbon emissions across portfolios of assets, prompted by the reporting requirements of the CRC Energy Efficiency Scheme (formerly the Carbon Reduction Commitment). However, we seem to be living in a dark age of carbon innumeracy where there is little hard data on the costs and benefits of remedial work and no agreement on the value of a tonne of carbon saved.

Figure 1: Sweett base buildings model

Building	Services	Plan depth	Age	Glazing
Office 1	Heating only	Narrow	Pre-1940	single
Office 2	Air-conditioned	Narrow	Pre-1995	double
Office 3	Air-conditioned	Deep	Post-2002	double
Office 4	Air-conditioned	Deep	Post-2006*	double
Retail	Air-conditioned	Deep	Pre-1995	double
Industrial / warehouse	Heating only	Deep	Pre-1995	single

Note: Office 4, built to comply with the 2006 version of the Part L Building Regulations, was introduced to demonstrate how the latest 2010 regulations would impact on its EPC rating.

Source: 'Costing Energy Efficiency Improvements in Existing Commercial Buildings', published by the IPF Research Programme in July 2012

The cost of carbon for CRC purposes is set to rise from the current £12 per tonne to £16 per tonne in 2014-15 and to be inflation linked thereafter. Yet this bears little relation to the social cost of carbon which was estimated to be US$85 per tonne in the Stern Review under a 'business as usual' scenario. These conflicting signals make investment decision-making very difficult. Where should capital be focused to achieve the best results in terms of reducing both carbon emissions and risk mitigation?

Louise Ellison, Manager, Responsible Property Investment, PRUPIM

Last October, an IPF Research Programme report sought to add clarity to this uncertainty. The research, undertaken by Sweett Group (UK) Ltd, set out the financial costs and benefits of retro-fitting improvements aimed at reducing a building's carbon emissions[2]. Prior to this work, the bulk of research on building efficiency focused on new build, which only comprises a small proportion of the current stock.

The IPF study analysed over 20 types of possible upgrades across a range of typical building types (see Figure 1). In each case, the costs of installation were estimated and the benefits in terms of energy saved and carbon emissions averted, calculated. It was assumed the buildings would be upgraded to at least market standard so the work focused on the extra energy and carbon savings that were potentially available over and above this.

Gerry Blundell, Consultant

Financial returns from upgrades

This article builds on the Sweett study's findings. We have estimated a simple measure of the financial returns to each upgrade, focusing on the four offices analysed in the study (see Figure 2). We have then estimated an external rate of return (ERR), i.e. the return generated by factors beyond the investment itself, by placing a financial value on the CO_2 saved each year by each upgrade.

Results are set out in the four left-hand columns of Figure 3 for each of the four types of office. Internal yields are based on valuing carbon savings at zero but taking into account CRC payments avoided (priced at the current rate of £12 per tonne). The figures represent the annual saving in energy costs and CRC less a 10-year write-down of the capital invested. This depreciated net income flow is turned into a yield by dividing it by the initial capital cost. No account is made of potential capital allowances. A 10-year life was considered to be the most realistic assumption as although many of the upgrades would, in themselves last longer, it is probable that after 10 years, the building itself would undergo further significant work.

1 See www.ipf.org for details.

2 'the Cost of Improving Energy Efficiency in Existing Commercial Buildings' pp16/18 Investment Property Focus, Issue 21 July 2012, and the full report published in October 2012.

Figure 2: Office base buildings in more detail

Office	Footprint	Glazing level (%)	Glazing tpe	Lighting	EPC	Temperature control
1	15x60m	50	single	T12	D	Heating only/windows
2	15x60m	50	double	T12	F	Air-conditioned
3	30x30m	80	double	T8	F	Air-conditioned
4	30x30m	80	double	T8	E	Air-conditioned comprises centralised system and fan coils

Figure 3: Depreciated annual returns on energy saving improvements[1]

Upgrade	Office 1		Office 2		Office 3		Office 4	
CO_2 value (£/tonne)	0	70	0	70	0	70	0	70
Depreciated annual returns	%	%	%	%	%	%	%	%
Daylight sensing lights	25	33	80	101	7	11		7
Variable speed pumps	10	16	62	78	61	77	60	76
95% power correction	6	9	55	69	66	83	–	–
New T5 lighting	8	12	15	21	19	26	13	18
95% efficiency boilers	22	33	–	6	–	–	–	–
Improved air tightness	10	17	5	10	–	–	–	–
Chiller CoP 5.4	–	–	35	45	29	38	7	10
DC driven fan coils	–	–	5	8	11	15	14	19
SFP 2.0W/l/s	–	–	–	–	45	49	–	–
Heat recovery	–	–	–	6	–	–	–	–
Local heating controls	–	5	–	–	–	–	–	–
CO_2 saving (kg/m^2/pa	**11.8**	**13.4**	**27.7**	**31.9**	**26.7**	**26.7**	**15.3**	**16.3**

Note: (1) only returns of 5% or more have been shown (2) energy prices based on DECC central projection
Source: **Costing Energy Efficient Improvements in Existing Commercial Buildings**, IPF 2012

Figure 3 shows only financial returns of more than 5% per annum because anything less would be likely to dilute overall returns to the asset, bearing in mind that current expectations for total UK property annual returns are in the range of 6% to 8% over the next five years. Results suggest that there are a number of retro-fitting initiatives not part of a standard upgrade that make good financial sense: daylight sensitive controls on lights; and variable speed heat pumps pay for themselves within two to three years. However the very significant variation across the four types of office illustrates just how different individual circumstances can be, and highlight the limitations of a blanket approach.

While some of the upgrades show high returns, they actually save relatively little CO_2 per sq m. Variable speed pumps show yields of over 60% in office 2 but only save 1.6kg of CO_2 per year. By contrast, passively chilled beams in the same structure would save 19.7kg CO_2 but are so expensive that over a 10-year life would show a return of -5% per annum. This suggests that sticking to the improvements that make financial sense will simply not be enough to meet government carbon reduction targets; implying further penalties and incentives to come.

Pricing carbon emissions

So is it wise for investors to price carbon savings at zero? We would argue not. Under mandatory carbon reporting, from April 2013 all firms quoted on the main London Stock Exchange will have to report their total annual carbon emissions in their next annual report and accounts, and annually thereafter. This is forcing the pace in terms of data collection on carbon emissions – accountants like to be able to verify the numbers in annual reports – and simultaneously revealing to companies where their major sources of emissions, and therefore potential reductions, lie. Occupiers are inevitably becoming increasingly carbon sensitive, as are institutional investors. Carbon is unlikely to be seen as zero cost for long and, for many businesses, the property they occupy represents a significant proportion of their carbon emissions.

Third-party investment managers are already being judged on their ability to demonstrate good environmental, social and governance credentials. The rise in requests for information from investment consultants and the expectation that fund managers are signatories to cross-sector voluntary codes and standards bears witness to this. The policies and processes that fund managers have in place to limit their carbon impacts are already an important part of these credentials. If what owners, managers and occupiers say in public is to have any real meaning and bear scrutiny, it follows they should place a positive social value on carbon saved so they can make rational decisions about the best way of doing it. However, this immediately begs the question, what is that value?

At the time of drafting (March 2013), carbon emission permits are trading at just €3.9 per tonne, lower even than the price of CRC allowances – the true social cost is almost certainly higher than that. So while CRC costs are due to rise, a business with a customer base that is increasingly concerned about environmental impacts and/or that seeks to differentiate itself from competitors through its management of climate change risks, could already value carbon emissions averted much more highly.

To explore this, we applied the HM Treasury figure of £70 per tonne (used to price impact assessments) as a social cost of carbon and then reworked the returns in Figure 3, the results being shown in the four right-hand columns. As one would expect, the ERR rises and several additional upgrades become viable at the 5% threshold; notably local heating systems and heat recovery.

Given the results in Figure 3, why are these upgrades not part of the standard refurbishment? The answer lies partly in the nature of the typical UK commercial lease: The owner pays for the improvement but the occupier gets the benefit of any reduced energy costs. But it also lies in the lack of awareness of the significance of the issue to the business and a lack of robust data on which to base decisions. The scale of the potential benefits and investors' need to mitigate uncertainty suggest there are arbitrage opportunities in both aligning the interests of owners and occupiers and in better understanding the potential for improving the assets in your portfolio.

To emerge from the carbon Dark Age, we need to account for CO_2 emissions as we do money. The IPF study is an important step on a long road. Detailed analysis of the carbon savings generated by specific solutions on specific buildings over time, is a critical part of the process. We would further argue that firms should adopt an explicit commitment to the value they place on carbon saved; so doing will make their commitment transparent and accountable, and provide them with a rational basis for action.

Protecting value in real estate: Actions by responsible European real estate practitioners

Tatiana Bosteels, Head of Responsible Property Investment, Hermes Real Estate

Chair, Property Programme, Institutional Investors Group on Climate Change (IIGCC)

Across Europe, serious concerns over climate change and resource efficiency have led to the adoption of ambitious targets to cut greenhouse gas emissions. This drive is requiring owners and occupiers of buildings to comply with ever more stringent sustainability regulations.

Renovate Europe Campaign[1]

'The potential savings from renovation of buildings could equal a total of between €100 to €170 billion each year to 2020. Moreover, by harvesting these investment opportunities the EU Member States could stimulate economic activity at an appropriate time, which can give rise to jobs for 750,000 – 1,500,000 people.'

As a result of these regulatory and market changes, a large number of experts in the market believe that investment decisions made today on green building characteristics will impact the financial performance of real estate investments in the near future. This is clear in publications from a range of organisations representing trillions of US dollars under investment, including the principles for responsible investment (PRI)[2] and the institutional investors group on climate change (IIGCC)[3].

The evolving regulatory landscape, market preferences and impact on long-term value are causing tangible shifts in market behaviour. Indeed, in response, investors are no longer waiting for empirical evidence of impact to financial performance from valuation analysis. Institutional investors and their investment managers across Europe have already started to embed green building programmes throughout their real estate investment and asset management practices in order to mitigate these investment risks and enhance long-term value.

The latest UN Environmental Programme Finance Initiative's (UNEP FI) report, What the leaders are doing[4], and examples from investor members of IIGCC's Property Programme show the scale of adoption of such practices with initiatives and case studies across the whole process of real estate investment management and its supply chain on a global basis. Occupiers in Europe are also responding to regulatory pressures and consumer demand by implementing environmental, social and governance (ESG) policies. This is important given the role behaviour plays in defining the potential efficiency and performance of a building – see Figure 1.

This change in behaviour is happening along the real estate practitioner chain. Property managers are responding to the demand of their investor clients by creating sustainability management services. Valuers have started to take a more proactive role in understanding the new market dynamics and the impact of green characteristics of buildings. These initiatives show the extent to which sustainability characteristics are today being included in investment and asset management processes.

In addition to the work done by individual practitioners, numerous associations and sector organisations have emerged to promote, develop and standardise sustainable real estate practice and measurement, as outlined in Figure 2. These organisations and their work play a fundamental role in strengthening the momentum of the responsible investment 'revolution' and, importantly, increasing data availability and comparability across the real estate sector.

There are many tools and initiatives out there to help the sector adapt. The challenge is to seize on this opportunity to protect and add value to real estate investments, while scaling up the sustainable buildings and energy efficiency sector to a size aligned with the needs of society today, and at the same time stimulating economic activity and job creation, and delivering substantial health benefits.

1 Copenhagen Economics, October 2012: The multiple benefits of investing in energy efficient buildings renovation programmes and their impact on public finances in the EU. Commissioned by the 'Renovate Europe Campaign'.

2 Principles for Responsible Investment, September 2012: The environmental and financial performance of buildings – A review of the literature. PRI property working group.

3 Institutional Investors Group on Climate Change, (IIGCC), March 2013: Protecting real estate value: managing investment risks from climate change.

4 United Nations Environment Programme Finance Initiative (UNEP FI), Dec 2012: Responsible property investment: What the leaders are doing, 2nd edition, produced by the property working group of the United Nations Environment Programme Finance Initiative.

5 International Energy Agency, November 2012: World Energy Outlook 2012, www.worldenergyoutlook.org.

Figure 1: Actions taken today by responsible European real estate practitioners

Property investors with interests in indirect and equity investments

- Setting minimum responsible management and sustainability standards for investment in a listed or non-listed real estate fund.
- Inclusion of climate change and sustainability criteria in asset allocation and standard investment appraisal processes.
- Investing in dedicated green real estate funds.
- Private equity real estate fund benchmarking companies within selected indexes against a set of precise environmental indicators.
- Investing in companies developing technologies and products that will enable scaling up sustainable buildings and energy efficiency gains.
- Engaging with companies while monitoring companies' environmental performance.
- Actively contributing to policy and sector wide development of sustainability toolkits and benchmarks.

Property investors with interests in direct investments

- Launching dedicated green real estate funds or embedding responsible investment principles in the core of the investment practises of property funds.
- Understanding climate and sustainability risks and opportunities to portfolios and building assets, such as assessing portfolio risks to evolving building codes and regulatory changes.
- Inclusion of sustainability criteria in stock selection, such as carrying out sustainability risk assessments prior to acquisitions.
- Setting minimum sustainability standards for investment in individual buildings.
- Implementing minimum sustainability requirements for refurbishment and developments.
- Implementing environmental efficiencies in day-to-day management of buildings to drive operational cost savings.
- Working with tenants to achieve environmental objectives through formal green clauses in standard leases, sustainability memorandum of understanding or informal sustainability groups.
- Implementing responsible supply change policies with suppliers and sub-contractors.
- Implementing flood risk assessment, disaster preparedness plans.
- Actively contributing to policy and sector wide development of sustainability toolkits and benchmarks.

Occupiers

- Large corporate occupiers including as standard minimum sustainable and energy certification levels for building they wish to occupy (BREEAM, LEEDs, HQE, DGNB, Minergie, EPC, DEC).
- Acceptance of green lease clauses in standard leases becoming more mainstream and better understood.
- Occupiers bringing their own green clauses to the lease negotiation table.
- Signing up sustainability memorandum of understanding with owners of buildings they occupy.
- Including requests for green refurbishment in rent renewal negotiations.

Property managers and agents

- Driving the sustainability agenda ahead of their clients in view of the market potential for such services.
- Actively contributing to sector-wide development of sustainability toolkits and benchmarks.
- Surveyors including environmental and sustainability assessment in standard building survey services.
- Letting and leasing agents are mandated to advertise energy performance certificate in their marketing material.

Lawyers and consultants

- Lawyers advising occupiers and owners on the impact of green leases and climate and sustainability regulations, such as carbon taxes.
- Consultants advising clients of investment risks from changing sustainability legislation.

Valuers

- Engaging with owners to collect sustainability data as part of standard valuation assessments.
- Working on DCF models taking account of sustainability metrics.
- Working with sector organisation to educate the sector. Such as the RICS advisory paper on sustainability and valuation[5].
- Supporting development of sustainability questionnaires and benchmarks: IPD and RICS launching the EcoPAS (see Figure 2) in the UK and now expanding to France and the Netherlands.

Figure 2: Real estate sector responsible investment tools and methods

Better Buildings Partnerships toolkits

In the UK the Better Buildings Partnership (BBP) has developed hands on, practical toolkits to enable the uptake of sustainability in the built environment, targeting the various practitioners of the real estate market[6]: Transactional Agents; Green Lease; Managing Agents; Sustainability Benchmarking; Green Building Management; Low Carbon Retrofit; Better Metering.

Green Rating Alliance – The Green Rating tool[7]

The Green Rating tool is a sustainability assessment of a property based on six key performance indicators to assess, improve, communicate and benchmark sustainability performance. The tool has now been used over 4m square metres of European property, and the data collected is used to develop a benchmark on buildings' environmental performance.

Global Real Estate Sustainability Benchmark (GRESB)[8]

GRESB aims to assess the sustainability of whole real estate portfolios for property companies and real estate funds and enable institutional investors to have informed engagement with their investment managers. It benchmarks the funds sustainability 'Management & policy' and 'Implementation and measurement' performance. The 2012 GRESB survey saw submissions from almost 450 asset managers around the world representing US$1.3bn of assets under management.

Global Reporting Initiative Construction and Real Estate Sector Supplement (GRI CRESS)[9]

Provides a global set of standardised indicators and reporting methodologies.

IIGCC guide for pension funds on managing investment risks from climate and sustainability[10]

Supports responsible institutional investors to understand and mitigate investment risks in this area.

IIGCC guide for pension funds reporting for property investment portfolios[11]

Highlights simple and accessible indicators that would enable a pension investment manager to evaluate a property investment manager's absolute and relative performance with respect to managing the environmental impacts of their portfolios.

IPD EcoPAS, Eco Portfolio Analysis Service

IPD EcoPAS helps to understand the potential environmental risks of investment portfolios. It focuses on environmental variables likely to impact asset and portfolio values, as well as performances. It provides a risk analysis of whole portfolio and compares exposure with other market players.

INREV[12] and EPRA[13] sustainability reporting guidelines

Based on the GRI common methodology provide simplified and standard methods for investment managers to report their sustainability performance.

The International Sustainability Alliance (ISA)

A global network of leading corporate occupiers, property investors, developers and owners. Its aim is to bring together worldwide leading commercial organisations with substantial property assets and committed to achieving higher sustainability in the built environment. The ISA provides detailed benchmarks of different type of buildings across geographies.

6 Better Buildings Partnership, from 2009: **Sustainability toolkits**. Available at www.betterbuildingspartnership.co.uk/media/tollkits

7 Green Rating Alliance (GRA): **Green rating assessment**. Available at www.green-rating.com

8 Global Real Estate Sustainability Benchmark (GRESB), September 2012: **2012 GRESB report**. Available at www.gresb.com

9 Global Reporting Initiative (GRI), 2011: **Construction and real estate sector supplement**. Available at www.globalreporting.org.

10 Institutional Investors Group on Climate Change, (IIGCC), March 2013: **Protecting real estate value: managing investment risks from climate change**.

11 Institutional investors group on climate change (IIGCC), July 2010: **Climate impact reporting for property investment portfolios. A guide for pension funds and their trustees and investment managers**. Drafted by the IIGCC property working group. Available at www.iigcc.org

12 European Association for Investors in Non-listed Real Estate Vehicles (INREV), January 2012: **Professional standards: Sustainability Reporting recommendations**. Available at www.inrev.org/attachments/article/221/INREV_Sustainability_Reporting_Recommendations.pdf

13 European Public Real Estate Association (EPRA), September 2011: **Best practice recommendation on Sustainability Reporting**. EPRA reporting. Available at www.epra.com/media.EPRA_BPR_2011_sustainability.pdf

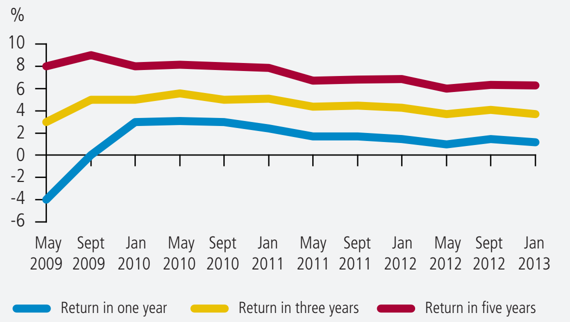
IPF Survey of IFAs
February 2013

The IPF Survey of IFAs is carried out three times a year and the results published in February 2013 are based on a survey of 248 advisers who generate 25% or more of their income from savings, investments or pensions.

Annual return expectations

As shown in Figure 1, IFAs appear generally more positive about annual property returns than in recent surveys, with the biggest change being registered for return expectations over a one-year period, where optimism has returned to previously recorded levels. 65% of respondents now expect a return of between 1% and 5% over one year, compared to 60% in September 2012. Overall, 73% of respondents believe returns will be positive over a period of one year, compared to 67% in the last survey.

Figure 1: Average expected annual returns from property investments



Source: IPF Survey of IFAs, February 2013

When asked about five-year returns, the largest group (41%) predicted returns of between 6% and 10%. Interestingly, over 20% of contributors consider total returns over five years could exceed 11% per annum. Average anticipated returns over one-, three- and five-year periods are 1%, 4% and 6% respectively.

Recommended allocations

Recommended property allocations have remained relatively stable, with 10% of IFAs advising that their clients should increase their property investment in this latest survey (see Figure 2). This compares to 9% in May 2012. The decline from a peak of 40% of advisors recommending allocation increases in January 2010 appears to have been arrested.

There has been a small increase (4%) since September in the proportion of IFAs stating that their clients' exposure to property is too low, with a total of 26% indicating their clients had a lower exposure than they would advise. Conversely, 35% of IFAs consider their clients have more exposure to property than they would recommend, broadly similar to the last three surveys.

IFAs report that their clients continue to expect an average minimum return of 3.4% above the risk-free rate for their commercial property investments. This level has varied little since September 2008.

Preferred locations and sectors

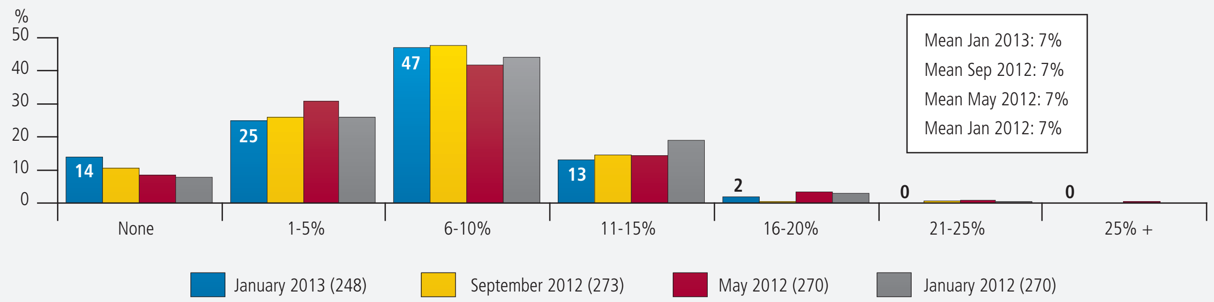
UK property continues to be the most likely location to be recommended by IFAs, with 63% indicating they would support investment in this market. Investing in global real estate is advocated by 44% and Asia is now recommended by nearly a quarter, almost double the level of recommendation in May 2012. Europe has also gained in popularity, now ranking alongside the USA.

Residential property investment, which declined in popularity in 2012, is currently the most favoured property sector after offices, which attracted support from 10% of respondents.

Investment vehicles

Almost half of the IFAs viewed UK-invested 'bricks and mortar' funds as providing the 'best' or a 'good' fit for their clients' property requirements. Similar funds investing globally were considered the next most compatible.

Figure 2: Percentage of a client's portfolio IFAs would typically recommend being allocated to property investment



Source: IPF Survey of IFAs, February 2013

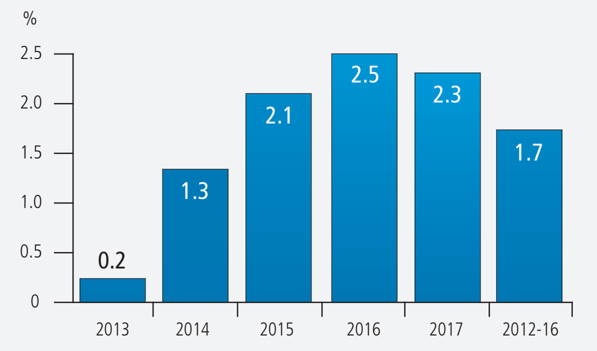
UK Consensus Forecasts
February 2013

All Property annual rental value growth forecasts

For the first time in five quarters, rental value growth expectations have finally turned positive, although 2013 is likely to deliver almost negligible growth.

The continuing fragility of the occupier market is reflected in predicted below long-run growth in every year throughout the consensus forecast period, leading to a five-year average of 1.7% per annum (versus over 3% per annum in the long-run), although this is an improvement over the 2012-16 average of 1.2%.

Figure 1: All Property rental value growth forecasts

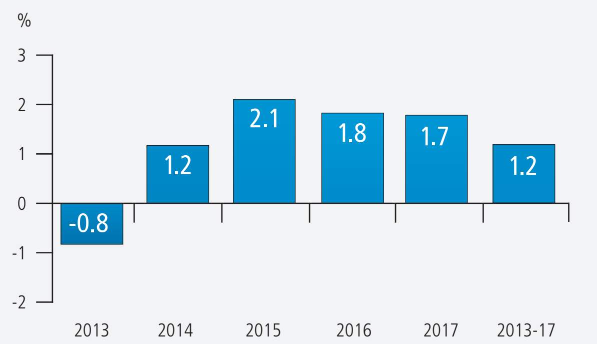


All Property annual capital value growth forecasts

The impact of negative capital value growth continues into 2013, with the current year's average forecast of -0.8% improving only slightly on the last survey's prediction (-0.9%).

Expectations that growth will peak in 2015 are maintained, whilst continued, albeit below average, growth in the residual years of the forecast period should lift the five-year average above 1.0%. However, this figure remains significantly lower than the long-run average (2.5% per annum).

Figure 2: All Property capital value growth forecasts

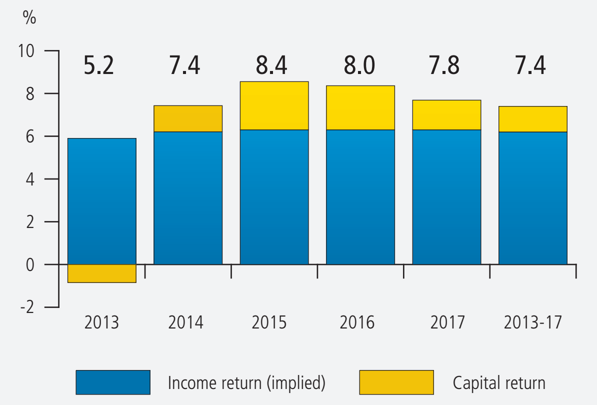


All Property annual total return forecasts

The All Property performance for 2013, as measured by total return, is expected to be adversely affected by negative capital value growth, thus relying on income to deliver a figure in the order of 5.2% (implying an income return of 6.0%).

Expectations of a return to positive capital growth in 2014 and throughout the remainder of the forecast period assist in increasing the five-year average to 7.4% (compared to 6.2% for 2012-16) made up of an implied income return of 6.1% and capital return of 1.2%.

Figure 3: All Property total return forecasts



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 forecaster' level only. **9.** There was one 'other' (non-equity broker) contributor this quarter, whose data is incorporated at the 'All forecaster' level only. **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 all 31 contributors, while sector forecasts are for reduced samples (27/29) of contributors.

Acknowledgements

The Investment Property Forum would like to thank all those organisations who contributed to the IPF UK Consensus Forecasts for Q1 2013, including the following: **Property advisors (including research consultancies):** BNP Paribas Real Estate, Capital Economics, CBRE, Cluttons, Colliers International, Cushman & Wakefield, Deloitte Real Estate, DTZ, Fletcher King, GVA, Jones Lang LaSalle, Knight Frank, Paul Mitchell Real Estate Consultancy Limited, Real Estate Forecasting Limited, Strutt & Parker. **Fund managers:** Aberdeen Asset Management, Aviva Investors, AXA Real Estate, CBRE Global Investors, Cordea Savills, Cornerstone Real Estate Investors, F&C REIT Asset Management, Henderson Global Investors, Ignis Asset Management, LaSalle Investment Management, Legal & General, PRUPIM, RREEF, SWIP, Standard Life Investments.

All Property survey results by contributor type

(Forecasts in brackets are November 2012 comparisons)

Figure 4: Property advisors and research consultancies (15 contributors)

	Rental value growth %						Capital value growth %						Total return %					
	2013		2014		2013-17		2013		2014		2013-17		2013		2014		2013-17	
Maximum	1.3	(1.4)	2.8	(3.7)	3.2	n/a	1.4	(3.4)	3.5	(4.0)	3.6	n/a	7.4	(9.5)	9.9	(10.6)	8.8	n/a
Minimum	-0.9	(-1.0)	-0.4	(-0.4)	0.8	n/a	-1.5	(-2.6)	0.0	(-1.2)	0.5	n/a	3.6	(3.3)	5.9	(5.0)	7.0	n/a
Range	2.3	(2.3)	3.1	(4.1)	3.1	n/a	2.9	(6.1)	3.6	(5.2)	3.1	n/a	3.8	(6.3)	4.0	(5.6)	1.8	n/a
Median	0.5	(0.6)	1.4	(1.6)	2.0	n/a	-0.5	(-0.3)	1.3	(1.0)	1.7	n/a	5.6	(5.7)	7.5	(7.3)	7.7	n/a
Mean	**0.3**	**(0.4)**	**1.5**	**(1.7)**	**2.1**	**n/a**	**-0.3**	**(-0.2)**	**1.5**	**(1.3)**	**1.6**	**n/a**	**5.7**	**(5.7)**	**7.6**	**(7.5)**	**7.8**	**n/a**

Figure 5: Fund managers (16 contributors)

	Rental value growth %						Capital value growth %						Total return %					
	2013		2014		2013-17		2013		2014		2013-17		2013		2014		2013-17	
Maximum	1.2	(1.5)	2.9	(3.3)	2.7	n/a	1.5	(2.4)	3.5	(4.8)	2.5	n/a	7.6	(7.2)	9.8	(10.9)	8.5	n/a
Minimum	-1.8	(-2.2)	-1.4	(-0.8)	-0.1	n/a	-4.1	(-4.1)	-1.0	(-0.4)	-1.1	n/a	2.0	(1.9)	5.2	(6.2)	5.1	n/a
Range	3.0	(3.7)	4.3	(4.2)	2.8	n/a	5.6	(6.5)	4.5	(5.2)	3.6	n/a	5.6	(5.3)	4.6	(4.7)	3.4	n/a
Median	0.1	(0.3)	1.0	(1.3)	1.3	n/a	-1.3	(-1.7)	1.1	(1.2)	1.0	n/a	4.7	(4.7)	7.3	(7.3)	7.0	n/a
Mean	**0.1**	**(0.1)**	**1.0**	**(1.3)**	**1.3**	**n/a**	**-1.3**	**(-1.5)**	**1.0**	**(1.4)**	**1.0**	**n/a**	**4.7**	**(4.6)**	**7.2**	**(7.7)**	**7.1**	**n/a**

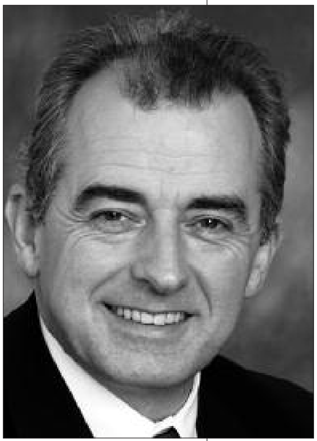
Figure 6: All forecasters (31 contributors)

	Rental value growth %						Capital value growth %						Total return %					
	2013		2014		2013-17		2013		2014		2013-17		2013		2014		2013-17	
Maximum	1.3	(1.5)	2.9	(3.7)	3.9	n/a	1.5	(3.4)	3.5	(4.8)	3.6	n/a	7.6	(9.5)	9.9	(10.9)	8.8	n/a
Minimum	-1.8	(-2.2)	-1.4	(-0.8)	-0.1	n/a	-4.1	(-4.1)	-1.0	(-1.2)	-1.1	n/a	2.0	(1.9)	5.2	(5.0)	5.1	n/a
Range	3.1	(3.7)	4.3	(4.5)	4.0	n/a	5.6	(7.5)	4.5	(6.1)	4.7	n/a	5.6	(7.6)	4.7	(6.0)	3.7	n/a
Std. Dev.	0.7	(0.9)	0.7	(1.1)	0.7	n/a	1.1	(1.6)	1.2	(1.4)	0.8	n/a	1.2	(1.5)	1.3	(1.4)	0.7	n/a
Median	0.3	(0.5)	1.4	(1.6)	1.7	n/a	-0.8	(-1.0)	1.3	(1.0)	1.2	n/a	5.2	(5.1)	7.4	(7.3)	7.5	n/a
Mean	**0.2**	**(0.2)**	**1.3**	**(1.4)**	**1.7**	**n/a**	**-0.8**	**(-0.9)**	**1.2**	**(1.3)**	**1.2**	**n/a**	**5.2**	**(5.1)**	**7.4**	**(7.6)**	**7.4**	**n/a**

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

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

Constructing an Effective Rental Value Index



Paul McNamara, IPF Consultant

Since the early 1990s, the UK commercial property market has steadily moved away using relatively standard 25-year leases with five-yearly upwards-only rent reviews to make substantially greater use of rent-free periods, landlord capital contributions to tenants, and a growing range of other 'incentives'. As a consequence, the actual rent levels negotiated between landlord and tenant have become less dominant within lease negotiations, while other factors have grown in importance. In so doing, quoted headline rents have become bolstered by such incentives while 'effective' rents have increasingly become obscured.

Because of a lack of guidance to valuers entering data onto valuation software through the valuation process, the rental data supplied to index providers like IPD has evolved into a mixture of headline and effective rents. Some valuers record both headline rents and related incentives while others record effective rents directly and set most incentives to zero. In the absence of full information about lease terms, index providers are forced to record the rental figures given, introducing ambiguity and uncertainty into resultant UK rental value data series.

For those interested in studying rental data series historically or using them as a basis for statistically modelling future rental market conditions, this is complicated further by the impact of these other leasing terms on rental values varying with time. In a buoyant letting market, few incentives are offered to occupiers. This means the headline rent contracted closely reflects the effective rent. However, in a weak market, landlords offer more incentives to tenants resulting in headline and effective rents diverging substantially. As a consequence, the rental value indices based on such unqualified rental data inputs fail to capture the true level of volatility in occupier markets and the resultant rental histories, and the forecasts based upon them, become artificially smoothed.

Constructing an Effective Rental Value Index

In an attempt to address these problems, IPF has published Constructing an Effective Rental Value Index, under its Research Programme Short Papers series. Written by Professor Neil Crosby and Dr Steven Devaney of the University of Reading, the paper makes four main recommendations. These are as follows.

The effective rental valuations required for a performance measurement system should be provided from within the valuation and measurement systems, not directly by the valuers.

Crosby and Devaney recognise that the primary task of valuers is to produce capital valuations and the rental value assessments within these valuations are not designed for the subsequent calculation of rental value indices. Valuers should provide headline rents and all other relevant lease details when registering data on valuation software. However, in their view, it is for the valuation software providers and performance measurers to facilitate the calculation of effective rents from this data in accordance with an agreed industry approach.

A single method for determining effective rental values from data on headline rental values and incentives should be adopted within UK performance measurement systems. These calculations can be undertaken within existing valuation systems using existing capitalisation rate data and new fields on assumed lease term, rent review and incentives.

Crosby and Devaney review in detail the main methods for determining effective rental values. For such a calculation to be undertaken within valuation or performance measurement systems it needs to use already available information and be capable of operating without subjective inputs. Although they acknowledge that an explicit cash flow approach is technically superior, the method they propose avoids valuers needing to introduce subjective inputs. Their preferred approach applies a simple capitalisation rate-based conventional valuation of the headline rent, written off over a period equal to half way between the lease term and the rent review period (i.e. in the case of a 15-year lease with 5-year reviews, 10 years). This approach was compared to other approaches, using an explicit cash flow approach as a benchmark, and found to be the most consistent and objective method, showing least variation from cash flow model solutions.

The data collection process has to enable the incentives and lease terms underpinning valuations, not just those in the current lease, to be collected to ensure that both headline and effective rental value indices can be constructed.

If performance measurers are to collect headline rents then the data collection process must also enable associated assumptions to be identified in each case. This may require valuation software to be developed to provide both headline rental values and the ability to specify a related effective rental value, where appropriate, for the valuation function.

IPD should amend its Index Guide to include the requirement to use the RICS Red Book for provision of rental value data in the UK and to specify headline rental values.

The RICS Red Book defines market rent and the guidelines to this definition clearly indicate it should be a headline rental value, with valuers making assumptions as to the lease terms and incentives underpinning that rent. Although IPD issues clear instructions to its subscribers to use the Red Book when providing them with capital valuations; no similar instruction exists for rental values. Crosby and Devaney believe this now needs to be done.

If adopted, these changes could significantly improve the transparency and accuracy of two major performance indicators for the UK property market: rental values and equivalent yields. They could also help improve accuracy in rental forecasting models and offer opportunities for different types of forecast – not only of rent levels but also of changing trends in lease terms.

However, Crosby and Devaney recognise that the implementation of their recommendations requires the co-operation of the three main stakeholders. Going forward, valuers would need to record information that is currently a by-product of their valuation process, valuation software providers would need to create new data fields for their valuation packages, and performance measurers would need to develop new approaches to the analysis of rental values within their systems.

Industry consultation

On 29th January 2013, IPF contacted its members, the heads of property valuation teams at chartered surveying and accountancy practices, the RICS and other property industry bodies, and the academic valuation community to ask for their responses to these recommendations. The consultation process concluded on 15 March and resulted in 19 separate submissions comprising over 10,000 words of comment.

These responses are now being assembled and considered by Dr Paul McNamara, acting as a consultant to the IPF. A programme of round table discussions is being planned. The intention is to secure widespread agreement on both an agreed methodology for converting headline to effective rents, and on the actions required from the main stakeholders responsible for entering, transferring and extracting valuation data that would lead to a resolution of these issues and the creation of improved rental value indices for the UK commercial property market.

Copies of the IPF Research Programme Short Paper **Constructing an Effective Rental Value Index**, can be downloaded from www.ipf.org.uk.

Forum activities and announcements

We are delighted to announce that Max Sinclair of Hypothekenbank Frankfurt has accepted the position of Vice Chairman under Andrew Smith's Chairmanship, which starts in June. Max will become Chairman in 2014.

IPF Annual Lunch 2013

The Annual Lunch took place on Friday 25 January 2013 at the Hilton Park Lane, London W1. Allister Heath was the after-Lunch speaker. This event was kindly sponsored by Chase & Partners, Langham Hall and Valad.

Allister Heath speaking after the Lunch

Investment Education Programme

The Investment Education Programme 2012-13 has been running since October, with a further three modules being offered in this cycle. The next module will be Indirect Property Investment, taking place on 20-22 May.

If you are interested in taking a single module from this cycle, or following the full diploma in 2013-14, further information can be found on the IPF website.

We are delighted at the continuing popularity of the IPF Diploma. 15 students completed the Diploma in 2011-12, and 14 of them collected their certificates at a reception prior to the Lunch.

IPF Diplomas awarded 2011-12

Ewan Cameron Scottish Widows Investment Partnership
Emma Castledine TT Electronics
Gary Cooper Chartered Land
William Edwards Legal & General Property
Lindsey Hammond CBRE
Matthew Jarvis Legal & General Property
Paul Lawrence Ogier
Walter Love Deutsche Hypo
Peter Neal Henderson Global Investors
David Rodger Ignis Asset Management
Mark Russell Legal & General Property
Christin Schoeder Bouwfonds Real Estate Investment Management
James Scott The Crown Estate
Kerrie Shaw Cordea Savills
Charles Vincent Deloitte Real Estate, Deloitte

Prizewinners

Amanda Howard, Lindsey Hammond and John Story

Lindsey Hammond is this year's winner of the John Whalley Prize for best overall performance in the Diploma.

Kerrie Shaw is awarded the IEP Module Prize for the best performance in a single module.

Amanda Howard, Kerrie Shaw and John Story


12 of the IPF Diploma holders 2012 with John Story, Amanda Howard and Lydia Romero (front) and Sue Forster and Paul Batho (back)

25th Anniversary

We are currently putting together a programme of events and publications to celebrate the IPF's 25th Anniversary year, which starts in July. Please keep an eye out for details of these celebrations in the months to come.

Consultations

Recent responses submitted to consultations:

- Response to the European Commission, Directorate General Internal Market and Services questionnaire on long-term investment funds on 8 March.

Current consultations:

The IPF plans to respond to the following:

- Second FSA consultation regarding the UK's implementation of AIFMD. This follows European Commission's official publication of the Level 2 Regulations in December 2012, and several guidance documents by the European Sales and Marketing Association (ESMA). Responses are due by 10 May 2013.
- European Commission Green paper on long-term financing of the European economy – responses by 25 June 2013.

IPD/IPF UK Property Investment Awards

The 13th Annual Property Investment Awards were hosted by Berwin Leighton Paisner on 29 March. Sue Forster, Executive Director of the IPF and Phil Tily, Managing Director IPD UK & Ireland presented the awards.

10-Year Absolute Return Award winner - The Church Commissioners

10-Year Relative Return Award winners Hermes Property Unit Trust and Church Commissioners Total Real Estate

All IPD/IPF Property Investment Award winners

Journal of Property Research – offer to IPF members

The Journal of Property Research is an international journal that publishes research papers on primarily property investment, finance and development. The publisher of this title has kindly agreed to offer IPF members a discounted personal subscription rate of £42 for hard copy and online, or £33 for online only, for the complete volume year (4 issues). This compares with the normal personal annual rate of £200 for the print version.

If you would like to find out more about the Journal and download sample articles, please visit http://www.tandfonline.com/rjpr

To take up a subscription at the IPF member rate, please visit http://www.tandfonline.com/pricing/journal/rjpr20

Membership Survey 2013:
What did we learn?

Sue Forster, Executive Director, IPF

In late 2012/early 2013, members were invited to respond to a survey seeking their views on the services offered by the IPF. Over 21% of the membership responded and the findings are summarised below, together with the comparative figures from the 2009 membership survey where appropriate.

The profile of the respondents to the 2013 survey is pretty close to that of the membership as a whole, although the members from the IPF Northern and Scottish regions were slightly under-represented (11% compared with 15% of the membership) and members aged 35 years and younger were slightly over-represented (15% compared with 12% of the membership)

Becoming an IPF member

The top three reasons for joining the IPF remain the same as in 2009, namely:

- To meet others involved in commercial property investment/finance;
- To attend seminars/workshops;
- Because they were recommended by a colleague.

Given the relative importance of being recommended by a colleague, it is surprising that nearly half the membership has never proposed anyone for membership.

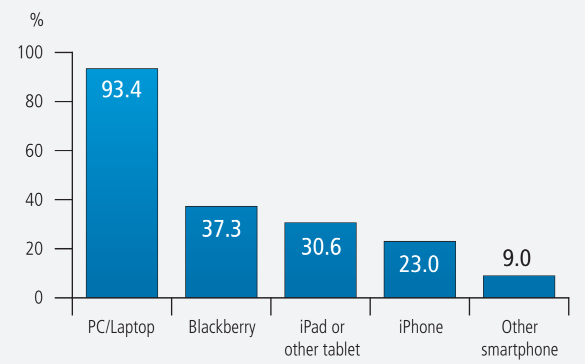
Some things have changed since 2009: The number of members paying their own subscription has grown significantly – 27%, compared with 19% four years ago.

Communication by the IPF

Just over 94% of the respondents thought that the level of communication by the IPF was about right. For the first time, some members (1%) thought that there was too much communication!

The most frequently used devices for reading IPF eNews and other IPF communications are shown in Figure 1.

Figure 1: Most frequently used device/s for reading IPF communications (total % of members ranking device 1 or 2)

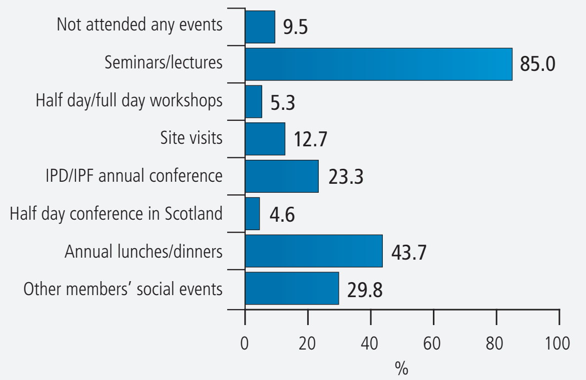


By far the two most popular modes of communication by the IPF are monthly round-ups by email and individual emails by event and/or research report. The third most popular, accounting for 31% of first and second preferences, is the IPF website. Perhaps this will rank higher still once the website has been upgraded, as planned for early 2014. Even without the upgrade, the use of the website has increased over the last four years. **Some 67% now book events online, 62% download research reports, 56% use it to get information about the IPF and its events and nearly 50% download speaker slides following seminars.** Only 13% of members do not use the website at all – an improvement on 27% in 2009.

Usage of IPF services

As shown in Figure 2, some 85% of members attended at least one seminar and 44% one or more of the IPF dinners and lunches in the last 12 months. Conversely, just over 9% did not attend anything.

Figure 2: Attendance at IPF events in the last 12 months?



The vast majority of members read at least some of Investment Property Focus and of the 4% who do not, over 84% of these mean to read it but do not have the time. We note that nearly 30% of members would now prefer an electronic, rather than paper copy.

IPF research was used on at least a quarterly basis by 70% of respondents, with less than 4% saying they never used it, compared with 7% in 2009. **The research topics were deemed to be interesting by 69%** and nearly 50% had found the output from the Research Programme to have been useful in their own work.

The level of the research is probably about the right, given that 8.8% said it was too technical and 3.3% thought it was not technical enough.

Overall, 92% of members responding said that the services

received from the IPF were good or excellent and the remainder thought that they were average. The annual membership subscription was deemed to be good or excellent value by nearly two-thirds, with just 1% considering it poor value or very poor value for money.

Other areas where the IPF should focus its attention

The survey asked whether the IPF should focus on other areas in addition to the five priorities identified in the 2011 Vision.

There were 100 responses to this question (23% of all survey respondents), suggesting issues such as emphasising property's place in a multi-asset portfolio, property in a defined contribution environment, alternative investments, international investment, investment performance, occupational issues, retail investors, secondary investments, sustainability and Scottish Independence.

We will endeavour to address as many of these as possible through the Research Programme, seminars and other outlets. For starters, please note:

- A major piece of research was published as four working papers by the IPF Research Programme in 2012 looking at the role of property in a mixed asset portfolio and this autumn sees the publication of another substantial piece of research, jointly with AREF, the Actuarial Profession and EPRA, on the impact of DC on the property industry.
- Sustainability is a key priority for the IPF and members of the Sustainability Interest Group are actively engaged with other parts of the industry through groups such as the Green Property Alliance, which is funding a major review of Carbon Incentives and Penalties, and in discussions with government on matters including the Green Deal and MEPS.
- The IPF will be spreading its 'international' wings a bit further this October when it will be sharing a stand at Expo Real with IPD Germany, following two years of holding seminars at the event. We hope to see as many members as possible during 7-9 October.
- For those wanting to debate the impact of Scottish Independence on the property market, do not miss the IPF debate and dinner in Glasgow on 12 September (booking will open shortly).

What else should the IPF be doing for its membership and/or the property industry generally?

The most frequently suggested ideas are listed below, together with comments as to what the IPF is currently doing about each one.

- **Set up a repository for research material, not just IPF research**;

Comment: This idea is being given active consideration by the Education Strategy Group.

- **Focus more on younger people in the investment/finance sector;**

Comment: In November 2011, the IPF set up the Next Generation Group, which runs additional events for members with between five and 15 years' post qualification experience. The IPF is also focusing more on the post-graduate investment/finance courses that it recognises and now offers free membership to these students while they are studying and fast-track full membership on passing their respective course.

Any IPF members who would like to join the Next Generation Group should contact Cheryl Collins, ccollins@ipf.org.uk, and if you would be willing to talk about your area of expertise and/or career at a Next Generation event, please contact Sue Forster, sforster@ipf.org.uk.

- **Increase the IPF's public profile/lobby more and build better links with other industry groups;**

Comment: The Management Board and Research Steering Group have both been discussing the need to increase coverage of the IPF's activities and research, not just in the property press but in other publications relevant to the particular issue. From now on, a press strategy will be in place for every piece of research published and for IPF initiatives, such as the recent consultation on Constructing an Effective Rental Value Index.

Unlike some other industry organisations, e.g. the BPF, the IPF is not a lobbying organisation. However, the IPF responds to all government and other consultations where it thinks it can contribute in accordance with its mission to enhance the understanding and efficiency of property as an investment. Such responses are either standalone (but generally after liaison with other organisations) or joint submissions with other organisations. A recent example of a joint submission with AREF and the BPF was to the Montague Review on increasing institutional investment in the residential sector.

The IPF is a founder member of the Property Industry Alliance (PIA), which now includes the ABI Property Committee, AREF, BCSC, BCO, BPF, IPF and RICS and ULI. The chief executives of these organisations meet three times a year and the PIA Board, comprising the respective president/chairman and chief executive of each organisation, also meets three times a year. In addition, representatives of the organisations sit on the different PIA interest groups covering green issues (GPA), occupier satisfaction (OSS Group), research, REITs and property debt. Non-PIA organisations are also invited to sit as permanent members of relevant groups, e.g. the Better Buildings Partnership, CoreNet and UK Green Building Council sit on the GPA.

IPF is represented on the Bank of England Property Forum and the UK Investment Performance Committee (UKIPC), the latter being responsible for continuing development and promotion of the use of transparent, consistent and ethical investment measurement performance standards (not just for property) in the UK.

In terms of events, the IPF works with the following organisations on a regular basis: APL, BCSC, BCO, BPF, IAS, INREV, IPD and SPR. The Forum is also collaborating currently with INREV, SPR and RICS on specific initiatives.

- **Focus more on international (especially European) markets;**

Comment: The International Special Interest Group was set up in 2009 to ensure that an international dimension was added to the IPF's research and educational activities. As well as UK-based events, e.g. the joint seminar with London School of Economics, the Group has organised events at MIPIM and Expo Real. It also hosted an event for IVBN (Association of Institutional Property Investors in Netherlands) when its members visited London – a blueprint for future collaborations in the future.

Mid-2012, the IPF became a founding member of the European Real Estate Forum (EREF), bring together the chief executives and other senior executives from ALFI (Luxembourg), AREF, Belgian Financial Sector Federation (Febelfin), BPF, Bundesverband Alternative Investments (BAI), Dutch Fund and Asset Management Association (DUFAS), EPRA, French Association of Financial Management (AFG), German Association of Closed-End Funds (VGF), German Fund Association (BVI), German Property Federation (ZIA), ICSC, INREV, IPF, IVBN (see above), RICS and the Swedish Property Federation (Fastighetsägarna). The initial trigger for this group was the research on Solvency II jointly funded by seven of the EREF member organisations. Since then, amongst other things, EREF has submitted a response to EIOPA's proposal to apply significant features of the Solvency II framework to the IORP Directive.

- **Provide more support for members who are unemployed;**

Comment: IPF members who are unemployed qualify for a 50% discount on their annual membership fee. The Management Board also decided at its meeting just prior to Easter that the IPF should re-instate its mentoring provision for those members who have been made redundant or are at risk of being so – more information about this to follow in eNews. If you would be interested in being a mentor, please let us know.

In 2009, the IPF launched a webpage where jobs likely to be of interest to IPF members could be advertised free of charge. This page was taken down when it proved difficult to persuade potential employers to use it. Any ideas as to how to make this operate more successfully if we were to reinstate the webpage would be welcomed!

- **Provide more informal networking events;**

Comment: We have had good feedback from the Investment Network events arranged jointly with Property Week that began in June 2011, and, more recently, the Next Generation, Not at MIPIM breakfast. We intend to continue these and arrange more informal events.

- **And finally, make sure the IPF does not become another RICS or BPF!**

Comment: We rely on our members to stop us doing this!

If you have any further ideas and suggestions and/or would like to be involved in realising the objectives set out in the IPF's Vision, please contact **Sue Forster, sforster@ipf.org.uk**.

About the Nick Tyrrell Research Prize

The Nick Tyrrell Research Prize has been established by INREV, the Investment Property Forum (IPF) and the Society of Property Researchers (SPR) to recognise innovative and high-quality, applied research in real estate investment.

The Prize is in memory of the work and industry contribution of Nick Tyrrell, who sadly passed away in August 2010. Nick was Head of Research and Strategy and a Managing Director in J.P. Morgan Asset Management's European real estate division. His research work was characterised by a combination of academic rigour and practical relevance.

1. The Prize

- The Prize includes the following elements:
  - an award of £2,000;
  - a certificate presentation (which may be held at one of the conferences / dinners organised by one of the sponsoring organisations);
  - the opportunity to present the paper at a seminar organised by the sponsoring organisations; and
  - the inclusion of the article (or a summary thereof) in one or more of the sponsoring organisations' publications;

All of the above elements may be changed at the discretion of the three sponsoring organisations and the IPF Educational Trust.

2. Prize criteria

- Papers should represent, in the opinion of the Judges (listed below), high-quality research that is:
  - innovative, original and timely;
  - relevant to the real estate investment industry (listed/unlisted, direct/indirect, equity/debt);
  - of publishable quality in a leading academic real estate journal (e.g., the Journal of Property Research); and
  - typically between 5,000 and 10,000 words.
- Both single author and joint author submissions are permitted.
- Preference will be given to those papers where one or more of the authors is associated with a real estate investment management organisation or similar, by way of a full-time or part-time position.

3. Submission of papers

- Papers should be submitted directly by email to the Secretary, as nominated by INREV, the IPF and the SPR, stating any involvement or sponsorship by third parties.
- The deadline for submission of papers is 31 May each year.
- Papers that have been submitted for other prizes may only be considered with the explicit consent of one of the Judges.
- Sponsored pieces may be submitted with the written consent of the sponsor. A copy of this consent should be included with the submission.
- Only completed research papers will be considered by the panel of judges. Proposals for papers may be discussed with the Secretary.
- Ideally, the Prize will be awarded to an unpublished paper, but papers may be considered that:
  - have been published in the academic or professional press no longer than one year before submission;
  - presented to a conference no longer than one year before submission; or
  - are being considered for publication at the time of submission.
- The Secretary will distribute the papers to the Judges. The Judges will not correspond on any submissions directly.
- The Judges are under no obligation to award the Prize.

4. Management of the Prize

- INREV, the IPF and the SPR will be responsible collectively for the administration of the Prize and will appoint a Secretary to liaise with the Judges and the IPF Educational Trust.
- The Prize will be funded by monies from the Nick Tyrrell Memorial Fund, which is administered by the IPF Educational Trust, an independent charitable body.
- Monies for the Prize will be raised by the three sponsoring organisations on an as-and-when basis. The three organisations will each be responsible for publicising the Prize and for all aspects of management.
- The three sponsoring organisations will each appoint one Judge to sit on the judging panel. An additional (fourth) Judge will be appointed collectively. All judges will serve a two-year term and may serve a maximum of two consecutive terms. The fourth Judge will act as Chairman.
- The judging panel should comprise individuals with broad and substantial experience from both academia and practice. At least one member of the judging panel will have experience of non-UK real estate markets.

5. Fund raising

- Funds will be raised for the Prize from the following sources:
  - members of the sponsoring organisations;
  - special events, such as the Nick Tyrrell Memorial Seminar (the first Memorial Seminar took place on 12 October 2011); and
  - corporate donations.

6. Other issues

- Should the Fund be unable to award the Prize due to insufficient funds and the three sponsoring organisations choose not to seek additional funds, the remaining monies in the Memorial Fund would be merged with those of the IPF Educational Trust, to be used at the discretion of the Trustees.
- Similarly, should all three sponsoring organisations choose to cease awarding the Prize, the remaining monies in the Memorial Fund would be merged with those of the IPF Educational Trust, to be used at the discretion of the Trustees.
- Should the Prize not to be awarded at any time during a four-year period, for whatever reason, the Prize would terminate automatically unless the three sponsoring organisations all agree otherwise.

Judges (2012/13)

Dr Robin Goodchild (chair)
Professor Colin Lizieri
Dr Brenna O'Roarty
Dr Neil Turner

Secretaries (2012/13)

Dr Paul Kennedy email: paul@pjkennedy.co.uk
Anne Koeman email: anne.koeman@gmail.com

IPF Investment Property Forum

25 YEARS

Join us to celebrate our 25th Anniversary

Annual Dinner 2013

Wednesday, 26 June 2013

The Grosvenor House, Park Lane, London W1

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

Ticket price: **£125 + VAT**

£150 inclusive of VAT @ 20% per person

The ticket price excludes wine and other beverages.

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

This event is kindly sponsored by:

LanghamHall *real estate fund administration*

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JONES LANG LASALLE *Real value in a changing world*