Investment Property Forum

The Journal of the Investment Property Forum
Issue No. 11 | November 2008

INVESTMENT PROPERTY

FOCUS

20

YEARS OF THE IPF
1988-2008

20:20 Vision

In this issue:

From the editor

Sue Forster, Executive Director, IPF

This edition of Investment Property Focus celebrates the 20th anniversary of the IPF. As the timeline of the last 20 years demonstrates, the IPF has grown from a standing start to an organization with 1,900 members; much has changed in the world of property; and even more in the wider world. Going forward, there can only be greater changes to come so in this edition we have done some crystal ball gazing.

We asked three former chairmen of the IPF to highlight the major changes in the property industry since 1988 and consider how the market may develop over the next 20 years. All three highlighted the move towards specialisation, the development of the indirect markets, a greater sophistication in property research, globalisation and the change of pace of doing business from the then new technology of the fax machine to the current speed of email. Looking to the future they thought property markets would become more complex, more globally integrated and more entwined with other capital and debt markets – necessitating greater education and training within the industry if we are to compete as an asset class.

In his overview of the short, medium and long-terms challenges facing the property industry, IPF President, **Sir David Clementi**, also identifies the development of the right skills base as a prerequisite for supporting this rapidly evolving market. At the very least this might ensure that we do not return to similar market conditions as now sometime in the future.

Neil Blake of Oxford Economics looks beyond the gloom of 2008-09 to prospects for a general upturn in 2011. However he stresses that economic crises are likely to re-occur periodically due to the ongoing existence of global financial imbalances. These imbalances are reflected in the shifts in global property investment, as considered by **Paul Marcuse** and **Elisabeth Troni** of UBS Global Asset Management. They argue that while the global regions favoured by investors change over time, there is still a strong case for property investment per se, not least because of the high proportion of total return that is derived from rental income, making it less volatile than investments more reliant on capital return.

So how do we value this income? **Alan Gardner** of Jones Lang LaSalle looks at the relationship of potential reversionary rental income and initial yields. Going forward he thinks that clever investors will focus not only on timing the market but also exploiting the relative pricing differentials across the property asset markets.

The CMBS market has been hard hit by the credit crunch but **Hans Vrensen** and **Mark Nichols** of Barclays Capital are optimistic that the market will recover, once the uncertainties surrounding performance and ratings have been resolved. In the meantime, they have developed a stress framework for testing CMBS deals to determine how bad things may get in the short term.

Not surprisingly, the data provided in this edition of Focus, including the IPF UK and European Consensus forecasts and the European sales volumes, provided by Real Capital Analytics, do not make cheerful reading. **Gerry Blundell** looks at the behavioural biases of forecasting and concludes that forecasters are loath to forecast negatives in their own asset class. It therefore falls to the equity brokers to lead the forecasts downwards until such time as we reach an inflection point at the bottom of the cycle.

Despite current economic climate, sustainability remains a key issue. **Louise Ellison**, the IPF's Research Director, outlines three of the sustainability research projects due for completion shortly. One of these looks at energy efficient refurbishments and suggests that technology is available to upgrade existing stock cost effectively and in ways that generate positive returns on capital. Energy efficiency will become yet more important once the Climate Change Bill receives Royal Assent – **Paul Rice** of Pinsent Masons explains the implications. Climate change may also be increasing the frequency of flooding – **Bill Gloyn** of Aon provides a timely update on the flood insurance market.

As ever, the IPF continues to provide a full events calendar, details of which are included in the Forum activities and announcements. This month also sees the launch of a new publication, 'Getting into Property Derivatives' – a reflection of how far the market has come in 20 years.

Editor
Sue Forster

Sub editor
Frankie Clay

Design and production
Kevan Enticott
enticott design
25 Bramfield Road
London SW11 6RA
tel 020 7978 4598
www.enticottdesign.co.uk

IPF executive

Executive Director: Sue Forster
sforster@ipf.org.uk
020 7194 7922

Membership & Marketing Director: Vivienne Wootten
vwootten@ipf.org.uk
020 7194 7924

Research Director: Louise Ellison
lellison@ipf.org.uk
020 7194 7925

Education & Research Manager: Frankie Clay
fclay@ipf.org.uk
020 7194 7928

Events Manager: Ingrid Styles
istyles@ipf.org.uk
020 7194 7923

Events Manager: Suleen Syn
ssyn@ipf.org.uk
020 7194 7926

Membership Co-ordinator: Pat Johnson
pjohnson@ipf.org.uk
020 7194 7927

Accounts Manager: Jenny Hooper
jhooper@ipf.org.uk
020 7194 7923

Investment Property Forum
New Broad Street House
35 New Broad Street
London EC2M 1NH
tel 020 7194 7920
fax 020 7194 7921
ipfoffice@ipf.org.uk
www.ipf.org.uk

20 years at a glance

1988
End of dual tax relief on mortgages

1988
Wimbledon FC win FA Cup

1988
Base rate rises from 8.5% to 13%

1988
RPI 4.9%

1988
Gatwick's North Terminal opened

29.5%

1988
Rover Group privatised;
sold to British Aerospace

1989
Stockley group sells off most of Stockley Park for £365m

1988
Construction begins at Canary Wharf-

1988
The Prince of Wales opens the Princes Square shopping centre in Glasgow

1988
Wereldhave NV acquires Peachey Property in a hostile takeover

1988 – 1990
Japanese and Swedish investors very active in UK property market

1989
Base rate reaches a high of 15%

1989
Construction starts on the Manchester Metrolink, the UK's first new generation on-street tramway

1989
RPI 7.8%

1989
Mark Dixon sets up Regus

1989
IPF UK Digest first published showing 1988 figures

1989
Prime City office rents reach over £60 per sq ft

15.4%

1989
BAe buys Arlington Securities for £278m

1989
Imry Merchant Developers is sold to Marketchief for £314m

1989
First MIPIM in Cannes

1990
Berlin Wall comes down

1990
End of Japanese economic bubble – the collapse lasts for over a decade

1990
RPI 9.5%

1990 – 1991
First Gulf War

1990
Pearl Assurance taken over by Australian financial giant AMP

1990
Sibec, Citygrove and Broadwell Land go into receivership

1990
Meadowhall Shopping Centre, Sheffield opens

1990
Lakeside Shopping Centre, Thurrock opens

1990
Completion of Broadgate, London EC2

1990
Caledonian Land (now part of MEPC) and the Rutland Group buys the industrial assets of the Scottish Development Agency in 140m deal

1990
Contractor, Rush & Tompkins goes into receivership

1991
Opening of Stansted Airport's new terminal (designed by Foster & Partners)

1991
Base ratet falls from 14% to 10.5%

1991
Start of the Yugoslav Wars

1991
Bank of Credit and Commerce International (BCCI) is shut down

1991
RPI 5.9%

1991
David Lockhart sets up Halladale

1991
Total bank lending on commercial property reaches a high of £41bn

1991
Sheraton Securities and Ford Sellar Morris go into receivership

1991
Enactment of the Property Misdescriptions Act, making it an offence to make of false or mis-leading statements about property matters in the course of estate agency business and property development business

1988 1989 1990 1991

1988
Investment Surveyors Forum established

1988
First president appointed – Michael Mallinson

1989
First evening event is held. Speaker: Alastair Ross Goobey, 'Buy High, Sell Low – how pension fund management works in practice'

-8.4%

1989
Inaugural ISF Dinner is held on 20 June at the Chartered Accountants Hall. Speaker: Roger Nightingale, economist at Smith New Court

-3.1%

1991
ISF meeting is addressed by David Lascelles of the Financial Times – 'The UK banking scene: Dire or just dreadful?'

Graph shows IPD All Property Index annual total returns

1992
Base rate falls from 10.5% to 7%

1992
UK leaves the Exchange Rate Mechanism (ERM)

1992
Conservatives win General Election

1992
Premier Football League launched

1992
Bombing of the Baltic Exchange

1992
RPI 3.7%

1992
Rosehaugh, Mountleigh and Olympia & York Canary Wharf go into receivership

1992
Investment Surveyors Forum becomes Investment Property Forum

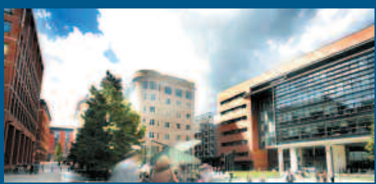
1993
RPI 1.6%

1993
Ron Spinney joins Hammerson as chief executive

1993
Chelsfield and Workspace Group (formerly London Industrial) are floated on the London Stock Exchange

1993
Speyhawk goes into receivership

1993
Development of Brindleyplace, Birmingham begins



1993
German open-ended funds buy their first office buildings in London

1993
Prime City office rents fall to £30 per sq ft

1994
Opening of the Channel Tunnel

1994
Sunday trading is legalised

1994
SMS text messaging first launched

1994
Orange mobile phone network launched

1994
Use of the World Wide Web to access the internet takes off

1994
RPI 2.4%

1994
Waterglade International goes into receivership

1994
Argent Group is floated on the London Stock Exchange

1995
RPI 3.5%

1995
Disability Discrimination Act (DDA)

1995
Collapse of Barings Bank

1995
Rugby Union turns professional

1995
Reopening of Tower 42 (formerly the NatWest Tower), London (the UK's first true skyscraper) following major refurbishment as a result of the IRA bomb in 1993

1995
Alastair Ross Goobey takes over as President of the IPF

1995
IPF Regional Board in Scotland established

-1.6% 20.2% 11.9% 3.6%

1992 1993 1994 1995

1996
Bombing of the Arndale Centre, Manchester

1996
RPI 2.4%

1996
Minerva is floated on the London Stock Exchange

1996
Launch of EGi

10.0%

1996
MOD Housing deal - first real estate securitisation deal

1997
Shell publishes first Corporate Social Responsibility report

1997
Princess Diana dies in a car crash in Paris

1997
Labour wins General Election

1997
RPI 3.1%

1997
Over 1,000 multiplex screens in the UK – the first 10 being built at The Point, Milton Keynes in 1985

16.8%

1997
Stamp duty increases from flat rate of 1%

1998
More mobile phones sold in 1 year than cars and PC's combined

1998
Good Friday Agreement signed in Northern Ireland

1998
Russian debt crisis

1998
Development Corporations established in the late 1980s are replaced by Regional Development Agencies

1998
Opening of Fosse Park Shopping Park in Leicester – currently has the highest retail park rents in the country

1998
RPI 3.4%

1998
Start of construction of the first buildings on GreenPark, Reading

1998
Starbucks enters the UK market

1998
Collapse of Long Term Capital Management Hedge Fund

1998
Opening of the Trafford Centre, Manchester – developed by Peel Holdings on a former wasteland site of 300 acres

11.8%

1998
Zara opens first UK store

1998
Merger of Cushman & Wakefield and Healey & Baker

1998
ProLogis kick starts its UK activities by acquiring Kingspark Group Holdings. The $157m deal included a land portfolio supporting about 32m sq ft of future development

1999
New Scottish Parliament

1999
National Assembly for Wales established

1999
Millennium bug paranoia

1999
London Eye opens

1999
Jubilee line extended to Stratford, taking in Canary Wharf

1999
Canary Wharf is floated on the London Stock Exchange

1999
RPI 1.5%

1999
Creation of the new English Partnerships with the merger of the Commission for the New Towns (CNT) and the Urban Regeneration Agency

1999
Bluewater Shopping Centre, Kent opens

14.5%

1999
Oracle Shopping Centre, Reading opens

1999
Lend Lease launches its UK Retail Partnership

1999
Merger of LaSalle Partners and Jones Lang Wootton to form Jones Lang LaSalle

1996 1997 1998 1999

1997
Kris Barnett (née Getvoldsen) made IPF's first Executive Director

1998
IPF celebrates its 10th anniversary

1998
First edition of Forum View printed

1999
IPF Membership reaches 1,000

1999
Advanced Education Programme launched

1999
First UK Consensus Forecast published

2000
Millennium 'Wobbly' Bridge opens

2000
Tate Modern opens

2000
Collapse of Equitable Life

2000
Pension funds required to state their social, environmental and ethical policy following amendment of 1995 Pensions Act

2000
RPI 3.0%

2000
Remainder of Rover Group is sold to the Phoenix Consortium for a nominal £10 and becomes the MG Rover Group

2000
CGU (formed from the merger of General Accident and Commercial Union) merges with Norwich Union

2000
Land Securities acquires Trillium

2000 – 2001
The following property companies go private: Allied London, Asda Property, Ashquay Group, Barlows, Bourne End, BPT, Burford Holdings, Capital Shopping Centres, Cathay International, Citadel Holdings, CNC Properties, Creston, Delancey Estates, Dencora, Frogmore Estates, MEPC, Moorfield, Orb Estates, Prestbury, Regalian, Raglan Properties, Scottish Metropolitan, Warnford Investments, Wates City of London

10.5%

2000
Prime City office rents climb back to £60 per sq ft

2000
Abbey National structured sale and leaseback of its entire property portfolio to Mapeley Columbus

2001
Base rate falls from 6% to 4%

2001
Labour wins General Election

2001
World Trade Center attacks

2001
FTSE 4 Good launched

2001
RPI 1.8%

2001
Creation of the 200 hectare freshwater lake at Cardiff Bay as part of the regeneration of 1,100 hectares of old derelict docklands of Cardiff and Penarth to form Europe's largest waterfront development

2001
Approval of the revised Bristol Harbourside master plan, the third attempt by developers Crest Nicholson to have plans accepted.

6.8%

2001
UNIQLO opens its first store in the UK

2002
Dot.com crash

2002
Euro introduced on 1 January 2002

2002
RPI 1.7%

2002
Hammerson acquires quoted publicly quoted Grantchester Holdings, giving it critical mass in the retail parks sector

9.8%

2003
Base rate reaches low of 3.5% in July

2003
Invasion of Iraq

2003
AMP Pearl, AMP NPI and AMP London Life were de-merged from AMP to become part of a new UK company called HHG

2003
RPI 2.9%

2003
Merger CB Hiller Parker and Insignia Richard Ellis to form CB Richard Ellis

2003
Opening of Castlepoint in Bournemouth, the UK's largest retail park (totalling 645,000 sq ft)

10.9%

2003
Completion of Paternoster Square, London

2003
Total bank lending on commercial property reaches £100bn

2000

2000
IPF Regional Board in the Midlands established

2000
First IPD/IPF Property Investment Conference in Brighton

2000
IPF website launched

2001

2001
Amanda Keane appointed as IPF Executive Director and Vivienne Wootten transfers from RICS to IPF

2002

2002
IPF Regional Board in the North established

2003

2003
Property Derivatives Special Interest Group (PDIG) is established

2003
First formal Research Programme established and Charles Follows appointed as the IPF's first Research Director

2004
England wins the Rugby World Cup and the Ashes

2004
RPI 3.0%

2004
The Planning & Compulsory Purchase Act sets out a new planning framework

2004
Opening of 30 St Mary Axe, London (the 'Gherkin')

2004
Marks & Spencer moves headquarters to Paddington Basin

2004
Greycoat goes into liquidation

2005
RPI 2.8%

2005
Chesterton goes bust

2005
The first over-the-counter UK property derivatives trade was executed

2005
Tesco raises over £600m from two sale and leaseback transactions

2005
Pillar Property is acquired by British Land

2005
The Royal Bank of Scotland moves to new global headquarters outside Edinburgh

2006
London is announced as the host of the Olympics in 2012

2006
RPI 3.2%

2006
London Tube bombings

2006
Argent gets outline planning permission for the main site at King's Cross, London

2006
Launch of IPD UK Quarterly Index

2007
RPI 4.3%

2007
Opening of the new Wembley Stadium, five years after the demolition of the old stadium.

2007
Sale of HSBC Tower for £1.1bn, 3.9% yield

2007
Introduction of UK REITs

2007
Derwent Valley takes over London Merchant Securities to form Derwent London

2007
Total bank lending on commercial property reaches £200bn

2007
Completion of Bridgewater Place, Leeds – the region's first 'skyscraper'

2008
Lehman Brothers goes bust

2008
Lewis Hamilton becomes youngest ever F1 world motor racing champion

2008
Base rate cut to 3% in November

2008
Opening of Heathrow Terminal 5

2008
Communities England formed from the merger of English Partnerships and the Housing Corporation. The new agency is tasked with delivering affordable new homes in sustainable communities

2008
Westfield Shopping Centre, London opens

2008
Developers, Highbridge Business Park, complete 1.25m sq ft of offices at Cobalt Business Park in North Tyneside. When completed it will be the largest business park in the UK

2008
Launch of IPD Global Index

18.3%
19.1%
18.1%

2004 2005 2006 2007 2008

-3.4%
-16.8%
(IPF UK Consensus Forecast)

2004
Membership reaches 1,500

2004
Sir David Clementi appointed President of the IPF

2004
IPF publishes the first edition of Understanding Commercial Property Investment: A Guide for Financial Advisors

2005
Sustainability Special Interest Group established

2006
First European Consensus Forecast published

2006
Second Research Programme launched

2007
Sue Forster appointed as IPF Executive Director and Louise Ellison appointed Research Director

2008
IPF celebrates its 20th anniversary

2008
IPF publishes Getting into Property Derivatives

20:20 Vision
Three Chairmen's perspectives

Louise Ellison, Research Director, Investment Property Forum

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

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

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

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

Modernisation and specialisation

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

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

Consolidation

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

Knowledge and data

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

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

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

Capital markets

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

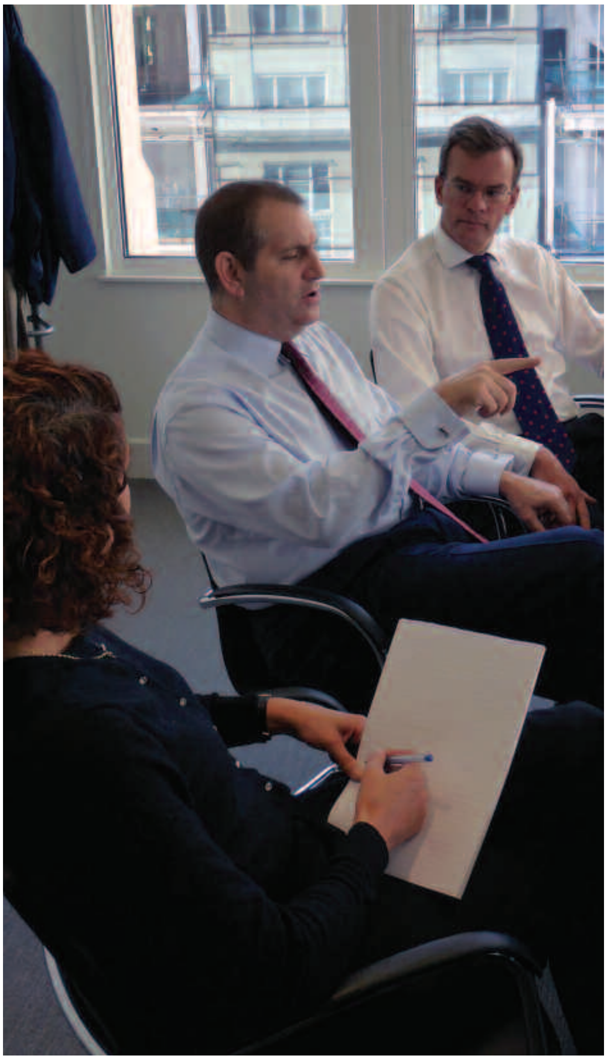
At times not being connected to a globalised world economy may seem attractive – particularly at the moment. But without it we would be a very small island. Andrew Hynard pointed out that "International money invested in the UK in the early 1990s particularly from the German funds was key to the revival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

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

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

Communications and technology

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



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

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

Recovering from the end of the last property market cycle

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

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

New forms of finance – debt and equity

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

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

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

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

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

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

REITs and property derivatives

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

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

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

Looking forward

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

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

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

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

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

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

Challenges for the property industry

Sir David Clementi, Chairman, Prudential plc & President, Investment Property Forum

Commercial property can be seen as part cause but certain victim of the current financial market and economic turmoil. Through the middle of this decade, overabundant supplies of cheap debt issued through a lax and undiscriminating underwriting process helped fuel a self-energising, investor-led cycle in residential and commercial property markets around the world. For many, commercial property came to be perceived as a high returning but secure asset; more rewarding than bonds, less risky than equities. As such, it was hardly surprising that capital poured into property. As capital values were driven yet higher, the apparent attraction of property to an ever widening array of investors grew stronger.

As prices ratcheted ever higher in an environment of already anaemic rental growth expectations, prospective returns to property fell. Experienced institutional investors began 'down-weighting' UK property and international investors began redirecting capital to more attractive international markets. As the credit crunch unfolded and debt became harder and more expensive to obtain we saw one of the great engines of the market, the leveraged investors, finally squeezed out of the market.

Demand for commercial property ground to a halt whilst the numbers looking for the exit grew. Capital values began to fall and the newly arrived retail investors quickly became net disinvestors, redeeming units in property funds and forcing even more stock onto the market, accelerating its downward spiral.

More recently, the UK market has entered a difficult 'second phase'. As troubles in the financial economy have cascaded into the real economy, tenant demand has begun to fall. This is most obvious in office markets but the retail and industrial sectors are also now in distress. One silver lining of the credit crunch was that it generally constrained a burgeoning development cycle. However, some markets, like the City office market, are experiencing supply spikes at just the wrong time and rents are falling sharply. As short term rental growth goes negative, the momentum behind yield rises and capital falls continues.

Thus, capital values across UK sectors stand some 25% – 30% lower than in June 2007 and the trend is still downwards, at 2% – 3% per month. Perhaps the only good news is that the UK led most other mature property markets around the world in both their recent market upswing and downswing and, having done so, is now priced competitively and could attract any floating international capital still seeking a home in property.

So, punch-drunk from both its change in circumstance and the continuing string of surprises sprung on it daily, what challenges face the property industry in November 2008?

In reflecting upon these challenges, we need to separate out the short to medium-term challenges, and what they might mean for the future operation of the commercial property market, from the longer-term challenges for the property industry, some of which existed before the current market episode and will remain long after it has passed.

Short-term market challenges

Given it is their job is to tap into the neuroses of industries at any given time, a review of property conference agendas provides a snapshot of what today's property industry is worrying about. Not surprisingly, the focus is on trying to see where we stand in the financial storm, how long it will be before light appears at the end of the tunnel, whether there are any strategies left to make money from the current and how best to operate property businesses in a low return, low transaction, world.

With respect to the obvious question, my colleagues at PRUPIM think that property yields still have some way to rise before stabilising. Despite pricing corrections having already restored direct commercial property to broadly 'fair value' in absolute terms, the existence of other cheaper assets, within and outside property, means it remains relatively expensive and it will take time before capital returns again to the direct property market. Values will, therefore, fall further before property can become competitive again. This process will unfold in an environment where rental growth takes a further 24 months to stabilise. Thereafter, a combination of improving rents and increased investor demand should help provide decent returns to property investors again.

Medium-term challenges for the industry

Much as we might wish it, as we look further forward, we need to acknowledge that commercial property cannot solve its own problems independently. Confidence will clearly need to return to the banking system before sufficient capital can re-enter the market and stabilise pricing in property markets. Notwithstanding the talk of substantial equity capital waiting on the sidelines, much of this needs debt to re-enter the market and this remains expensive and in disappointingly short supply.

However, there are things that the property industry could be doing to better ease itself into calmer waters. The themes are longstanding and ones the IPF has a clear and longstanding role in addressing.

The most obvious of these is to continue to remind the wider investment community of the many virtues of commercial property. In a recent survey carried out by PRUPIM and the Pension Management Institute (PMI), UK pension funds reiterated their continuing faith in commercial property, identifying diversification, the chance for excess returns, and the steadiness of income and total returns, as significant benefits commercial property provided for them. These are the benefits we must continue to promote.

Property remains a useful diversifier at the multi-asset level. Despite the falls witnessed recently, viewed long term property remains a reasonably stable asset class and should be seen as a positive. It is cold comfort but the property industry has wrung its hands over the level of capital falls in the past 18 months, but these falls were matched in some equities over weeks and even days!

As the pension funds surveyed noted, there is also the chance to make money from actively managing property assets and there is little doubt (and some comfort) that the current financial crisis has returned property to 'the professionals'. Market focus is now rightly switching back towards asset managers extracting added value from property assets and discerning investors selecting superior stock and moving away from the easy delivery of performance through blanket and ultimately unsustainable yield compression.

However, if we wish to ensure the best chance for capital to re-enter the market, we should also address several aspects of property that continue to act as barriers to further property investment.

First, the generally held perception of commercial property is that many of its practices are opaque. The valuation process in particular remains poorly understood and little trusted outside the property industry. Certainly for those within the industry, fierce attention will now be paid to how the valuation profession performs in the coming months. The thinness of the market and the lack of pricing evidence will not release valuers from the clear need to be even and consistent in their judgements on asset values. They will need to pool whatever evidence they can to serve their clients and the market best in the coming months. Failure to do so will invite material challenges to both their judgements and their collective reputation. Anything that can be put in place that promotes confidence and consistency should be well received.

Second, despite material improvement in information provision on the property market in recent decades, there is a clear need for yet more information. Historically, the call has been for more information about rental market dynamics. However, there is now a real need for the industry to collect better information generally on financial and investment related aspects of the property market. This is especially so with regard to the scale and nature of bank lending to property investors. The wider industry has been working blind with a generally poor understanding of the scale and nature of lending in the marketplace, at a time when the debt-driven investors had their hands on the steering wheel.

Third, the property industry needs to continue thinking about how to improve on its other major weakness: illiquidity. If property wants to attract more capital and promote itself as a 'thoroughly modern' asset, it must provide investors with better liquidity than currently. Innovations like property derivatives can help but the current downturn has again shown how quickly the direct property market seizes up. Perhaps even more concerning was the revelation that many of the collective vehicles, sold to investors partly on the strength of their prospective liquidity, proved just as (if not more) illiquid than direct property. The complexity of current property financing arrangements similarly sounds echoes of the problematic syndications of the early 1990s and their deleterious effect on decision-making and market liquidity. Old fashioned virtues of simplicity, transparency and quality look destined to make a welcome return.

Finally, rational expectations can be developed about what an asset class can deliver over the longer term, and when the prospective returns to property fell to only marginally above those from gilts and the risk premium for property fell close to zero, the writing was on the wall for property investors. Why then did the industry not react appropriately at that time, choosing instead to delude itself and press on? Any short-term gain from such action will be more than likely offset by long-term pain if investors become disillusioned or untrusting of the asset class. When the time is right, the property industry must return to the experience of recent years and learn their important lessons.

Longer-term challenges

However, despite short-term market travails, we should not lose sight of the longer-term challenges for the property industry. Issues we were actively discussing prior to the recent market episode remain. They are secular in nature and the market cycle should not divert us from thinking and acting on them.

The first of these longer-term challenges lies in understanding the changing nature of property as an asset class and its implication for property fund management. The days of investors managing their real estate equities, securitised mortgage and direct property portfolios as separate entities seem increasingly old fashioned. The likelihood of derivative variants of these underlying markets developing soon makes this doubly so. If property is an equity-bond hybrid, as it is often described, then investors will increasingly use the full panoply of 'property-type' investments to adjust the 'octane' of their property portfolios to match the market cycle. This means that property fund managers and indeed the property industry in general, will need to work hard to develop the right skills base to support this rapidly evolving asset class. The IPF and RICS have a crucial role to play in this.

One corollary of these structural developments is that the closer property comes to resemble and use the instruments seen in other asset markets, the more the property industry must submit to the right and proper disciplines extant in those markets. Similarly, increasing responsibilities and requirements will be placed on property fund managers to protect the interests of some investors, especially, the retail investor.

Looking more broadly, four major long term issues were identified by the Property Industry Alliance when it canvassed leading figures on their views of current property research priorities recently. These were sustainability, regeneration, the vitality of town centres, and mixed use development. If nothing else, this list shows clearly that the role of property in the social as well as the physical well-being of British cities will need to be given more thorough attention in the years ahead.

The same can be said of property's role in reducing the environmental impact of the current and future built stock. I note there has been comment recently that, in times of economic distress, sustainability naturally drifts down occupier and investor agendas. This seems perverse and seems rooted in the assumption that responsible actions necessarily cost more. It is just at times like this that cost and waste need to be reduced and if these issues are important to tenants and investors, which they seem to be, it is in weaker markets that more choice can be exercised over the buildings they occupy and own. Sustainability seems more rather than less important today.

Conclusion

Commercial property played a part in stoking the current financial crisis and is certainly experiencing some painful consequences. If the property industry is to avoid similar stress and trauma in the future, it is essential that it learns all the lessons it can from this ongoing and difficult experience. Increased regulation seems inevitable across the wider financial markets and property is unlikely to be immune from this.

Similarly, the property industry in general needs to develop a far better understanding and possibly stricter disciplines with respect to bank lending to the sector. It also needs to reflect honestly on the way in which property was marketed to newcomers to the asset class, especially non-professional investors, and how best it can service their needs going forward.

When calmer waters are reached, it is essential that the industry rigorously investigates the causes and learns the lessons of the last five years, and finds ways to ensure that current and future generations of property practitioner understand them well. If it doesn't, then we will be condemned to return to similar market circumstances at some time in the future.

Sponsorship opportunities for 2009

Annual Lunches & Dinners

Annual Lunch at the Grosvenor House, 28 January 2009
Approximately 1,000 property professionals in attendance.

Midlands Lunch at the ICC, Birmingham, 24 April 2009
Approximately 400 property professionals in attendance.

Annual Dinner at the Grosvenor House, 24 June 2009
Approximately 1,500 property professionals in attendance.

Midlands Dinner at the ICC, Birmingham, 8 October 2009
Approximately 600 property professionals in attendance.

Other regional lunches and dinners, dates tba in 2009
Approximately 250 property professionals in attendance.

Conferences

Annual Scottish Conference, 4 June 2009
Approximately 135 attendees.

IPD/IPF Property Investment Conference 2009, date tba
Approximately 400 property professionals in attendance.

If you are interested in sponsoring one of these events, please contact Vivienne Wootten on 020 7194 7924 or email vwootten@ipf.org.uk to discuss what is available.

Recognition

The level of brand exposure which an event sponsor receives before, during and after the event, might include some or all of the following:

- company logo printed on all marketing materials, invitations and menus
- acknowledgement in monthly e-newsletters
- one page advertisement in the Guest Booklet or Conference Pack
- company logo on the relevant IPF event web page
- display area during event
- logo animation on screen throughout the meal
- word of appreciation by the Chairman in his speech.

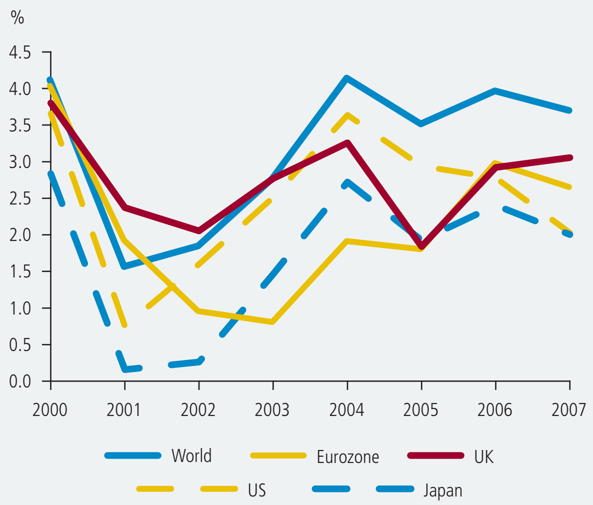
Challenging times ahead for the UK economy

Neil Blake, Director of Economic Analysis, Oxford Economics

Current economic challenges

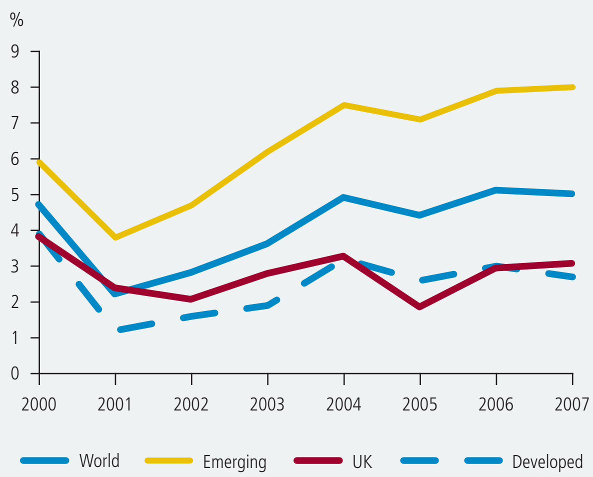
The global economy is facing its most challenging period in two decades, having enjoyed a golden period of economic growth since the post 9/11 recovery. Global growth averaged 4.6% between 2003 and 2007, underpinned by robust expansion from emerging economies (7.3%), in particular the BRICs (Brazil, Russia, India and China). Performance amongst the G7 was more mixed, with Japan and the larger Eurozone countries struggling, but the US growing in line with its long-term trend.

Figure 1: World GDP growth (countries)



Source: Oxford Economics/Haver Analytics

Figure 2: World GDP growth



Source: Oxford Economics/Haver Analytics

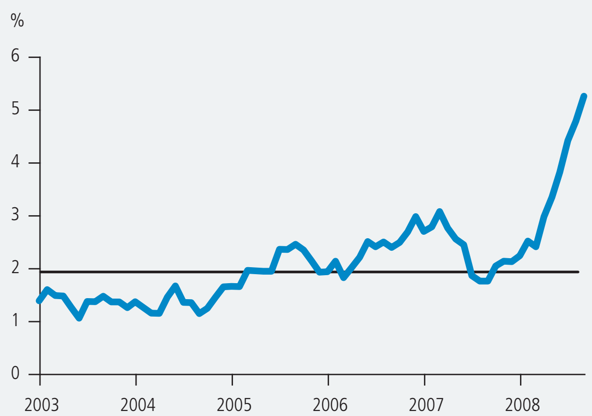
The UK economy enjoyed a five-year period of above-trend growth, driven by a housing market boom and robust consumer demand. There was a strong dependence on the financial & business services sector, with output growing at a rate of 7% a year over the past five years, which enabled London to establish itself as the pre-eminent region over that period. The success of the sector translated into strong job creation, though employment growth was largely confined to business services, with financial services firms gradually reducing headcount despite achieving robust output expansion.

However, this period of global economic success did have some less desirable consequences, particularly in terms of the impact on commodity prices. Surging demand for commodities, particularly from highly resource-intensive developing economies, combined with a number of supply disruptions to drive up prices. Non-oil commodity prices rose at a rate of nearly 15% a year between 2003-07, while oil increased from under $30 per barrel in 2003 to recent highs of more than $150, before slipping back in recent months.

Rising commodity prices have fed through into higher petrol prices – raising transport costs for businesses and consumers – as well as pushing up utility bills. Rising transport costs have also contributed to the significant increase in food prices, in addition to a number of disappointing harvests and strengthening demand from the developing world.

As a result, consumer price inflation has accelerated around the world. In the UK, the problem has become more acute in recent months because of the weakness of sterling, which has declined by 15% over the past year on a trade weighted basis, losing value firstly against the euro and then, more recently, falling sharply against the dollar. While this has been welcomed by exporters, who have received a boost to competitiveness, it has also raised the price of imported goods, adding to the inflationary pressures

Figure 3: CPI inflation



Source: Oxford Economics/Haver Analytics generated by rising commodity prices. And given that commodities are commonly priced in dollars, the loss of value against the dollar has also offset some of the benefits of the recent cooling in commodity prices. CPI inflation reached a 16-year high of 5.2% in September, more than double the Bank of England's inflation target.

Intensifying price pressures have been one of the factors behind the sharp slowdown in the UK economy this year. Earnings growth has failed to keep pace with rising price pressures, implying that real wages have fallen. With consumers having to spend a greater proportion of their income on food, utilities and petrol costs they have been forced to cut back on discretionary spending and, as a result, consumer demand has slowed sharply.

High rates of inflation made the Monetary Policy Committee (MPC) wary of cutting interest rates in the summer, even though there were already signs of an abrupt slowdown in the economy. They were concerned that rate cuts would make it appear that they were prioritising economic growth over inflation and feared that upward pressure on wages would be generated were consumers to believe that high inflation would become entrenched.

The challenge of rising inflation and slowing economic growth has been compounded by the credit crunch. The crisis had its origins in the US sub-prime mortgage market, but the UK economy has arguably been the most severely affected outside of the US. This is both because the use of securitised mortgages as a source of funds has dried up and partly because of worries over the soundness of many mortgage books in the UK. Commercial property finance has been similarly affected by the lack of demand for mortgage backed securities.

September has seen the most serious wave of financial turmoil since the credit crunch began in the summer of 2007. The US authorities have moved to take over mortgage giants Fannie Mae and Freddie Mac to prevent their collapse and have also been also obliged to effectively nationalise giant insurer AIG. There has also been the actual collapse of Lehman Brothers – the fourth biggest investment bank in the US – and the hasty sale of Merrill Lynch to Bank of America. This has caused an unparalleled period of volatility in global equity markets.

As the US economy has weakened, asset quality has continued to deteriorate, with mortgage delinquencies increasing further as house prices have fallen and default rates across other sectors rising. Rising default rates have added to the losses that banks had already suffered due to the drop in the value of structured products and leveraged loans. Financial institutions have struggled to raise enough capital to replace that eroded through losses, with global write-downs now totalling more than \$500bn and the amount of capital raised only \$350bn and there are not enough strong institutions able and willing to rescue the weak.

Financial markets have become increasingly jittery about the viability of a number of UK banks, causing wild fluctuations in their share prices. This forced the government to announce a £50bn bailout package to recapitalise the banks, in addition to approving the Lloyds TSB takeover of HBOS and nationalising Bradford and Bingley's mortgage book. Government intervention and backing for takeovers shows that a failure of a large UK bank is unlikely, but further consolidation is likely and there may be casualties amongst smaller institutions.

Though the rescue of Fannie Mae and Freddie Mac prevented a complete collapse of the US mortgage market, it will not alone be sufficient to prevent the slide in US house prices and UK banks exposed to US mortgage assets may still face further write-downs. These continued, or possibly greater, balance sheet strains may translate into a further tightening of lending standards. UK banks have cut back sharply on mortgage loans, but there is a risk that they will move to call in unsecured facilities and business loans too, which could trigger a spate of corporate insolvencies.

The events of the past two months saw LIBOR spreads rise above the levels reached in the first wave of market turmoil last year, reflecting the perceived increase in risk in lending money to other institutions. This has limited the effectiveness of the recent interest rate cuts and implies higher mortgage rates and borrowing costs in general for UK firms and households than would otherwise be the case.

The 'Paulson Plan', which would enable America's biggest banks to dump billions of dollars worth of toxic mortgage-backed assets into a federal-backed agency, is seen as essential for the restoration of some kind of normality to financial markets. However, a loosening in lending conditions is likely to be a gradual process – with no return to the excesses of recent years – and it will continue to weigh on UK economic prospects next year.

Outlook for 2009

Inflation looks to have peaked and, with commodity prices falling sharply and demand weakening, CPI inflation is likely to rapidly drop back below the 2% target. The MPC responded to the dramatic change in the outlook by cutting base rates by 200bp in two months and we expect rates to fall back to 2% in the coming months. However, it will take time for lower base rates to stimulate demand, particularly given the fragile nature of consumer confidence.

The rise in costs and reduced availability of mortgages pushed the housing market into a tailspin last winter and prices are currently some 14% below their peak according to the Nationwide and Halifax indices. Housing transaction levels are close to their 1993 low and prices are set to fall further next year, with the government's one-year stamp duty exemption for houses worth less than £175,000 likely to have little effect. Residential investment has already dropped sharply this year and is likely to fall further in 2009, while the decline in house moves has also hit areas of consumer spending whose fortunes are closely allied to the housing market, such as furniture and white goods.

GDP fell by -0.5% in Q3 2008 – a much larger contraction than was expected – and survey data points to a worse outturn in Q4. We expect the UK economy to contract by 1% next year, which would be the worst performance since 1991. The UK will not be alone in its struggles, with the US and Eurozone economies also expected to shrink next year. Many emerging markets will feel the impact of the sharp slowdown in the developed economies, particularly those reliant on exports in parts of East Asia and Central Europe, though the key economies of China, Brazil and Russia are expected to continue to grow robustly.

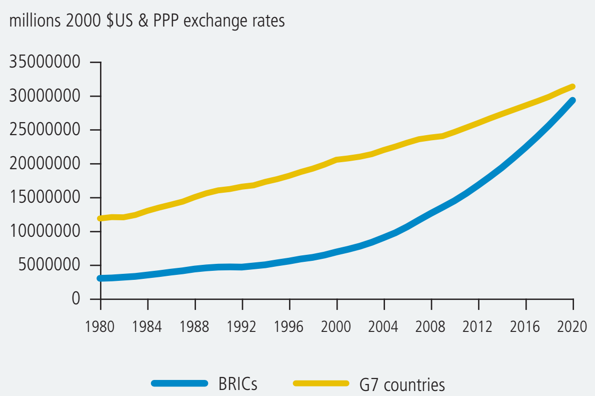
Few sectors are expected to escape the downturn. Official retail sales figures have held up in recent months, despite more gloomy survey data, but the fundamentals underpinning consumer demand are unsupportive so we expect to see sales fall over the rest of this year. The recent decline in manufacturing output is expected to intensify as export demand weakens in the face of slowing global growth. The weakness of sterling could provide some upside, though in recent months exporters have preferred to use this as a cover to increase prices in an attempt to rebuild margins decimated by rising input costs.

The contraction in the financial and construction sectors is likely hit prospects in London more than any other UK region, with GDP almost certainly set to fall sharply by 2009. The impact on financial and business services jobs will be significant, with a net loss of around 100,000 jobs over the next three years in London, equating to around 7% of employment in the sector. Nationwide, we expect the number of office jobs to decline next year, for the first time since 1993.

The recovery period

Though the near-term outlook is bleak, we expect the global economy to recover gradually from late next year as financial markets stabilise and the impact of looser monetary and fiscal policy feeds through.

Figure 4: GDP convergence

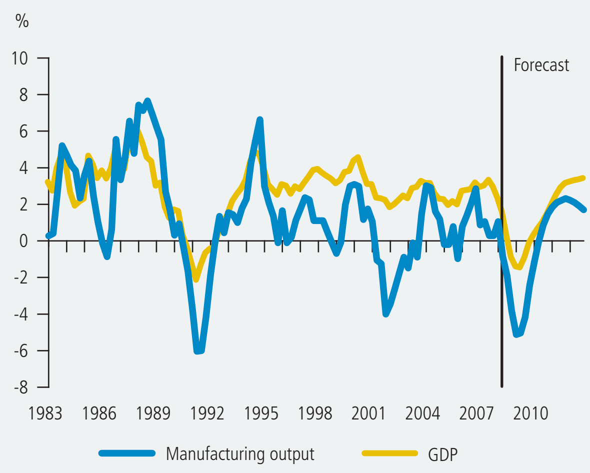


Source: Oxford Economics/Haver Analytics

That said, the recovery of the G7 economies is expected to be less rapid than in previous cycles. In the UK the triggers for past recoveries are unlikely to generate a rapid rebound this time around as high levels of household indebtedness provide less scope for a consumer-driven upturn. Weak demand in the Eurozone, the UK's largest export market, suggests little chance of an export-led pickup. We expect GDP growth to remain below the long-term trend until early 2011.

The government has formalised its commitment to using fiscal to aid the recovery process Policy in the Pre-Budget Report, abandoning its own fiscal rules and pledging to run large deficits through the recession. The measures are centered on a temporary VAT cut to 15% and the bringing forward of planned investment. However, the government must ultimately regain control over its finances so this fiscal stimulus has to be temporary. The Pre-Budget report also announced a package of tax increases as well as the reversal of the VAT cut which will come into force in 2010 once the economy is, hopefully, into the recovery phase. Tax rises and spending restraint are necessary both to pay for the announced fiscal stimulus and in order to reduce an already significant structural budget deficit.

Figure 5: GDP and manufacturing output



Source: Oxford Economics/Haver Analytics

The financial market turmoil of the past year will also leave a lasting legacy. Legislation to more strictly govern the behaviour of market participants is certain and the days of cheap and easily obtainable credit are over for the time being. The authorities are keen to limit the volatility of markets and to greatly reduce the chances of a repeat of the events of the past year, and this is bound to reduce the ability of the financial sector to post the exceptional rates of growth it has achieved in this decade.

The key drivers of property demand are likely to see a similarly gradual pickup. Office employment is expected to increase from 2011, but it will be another year before growth returns to the rates achieved over the first half of this decade. The recoveries in retail sales and manufacturing output will follow similar patterns, both lacking the momentum of previous upturns.

The credit crunch has had less of a direct impact on emerging markets, allowing these countries to continue to grow strongly even as the developed economies have slowed, and these countries will continue to lead growth in the upswing. China is expected to continue to grow at rates in excess of 9% a year for the next five years, with its fellow BRICs close behind.

The long-term outlook

Over the long term, we expect to see further changes in the world order. China will continue to grow strongly, benefiting from the boost to its capital stock of the massive investment surge of the past five years. This should help China to avoid the traditional bottlenecks and overheating problems associated with rapid expansion, enabling its economy to grow to a similar size as the US by 2020 (in purchasing power parity terms). The other BRICs are also likely to see continued strong growth, leading to continued convergence between the size of the old western economies and the emerging economies.

The UK is likely to remain the sixth largest economy in the world over the next decade, re-capturing and then extending its advantage over France and closing the gap on Germany but being overtaken by Russia. A flexible labour market and favourable demographics will underpin GDP growth of 2.5% a year on average in the UK. The current economic downturn may lead to a fall in inflows of migrant workers in the short term. This could be a threat to long-term economic growth if in-migration remained low but numbers should build up again as employment demand recovers.

We will continue to see significant political pressure on environmental issues. Nations will be encouraged to migrate to 'cleaner' technologies and to pursue more energy efficient policies, backed up increasingly in the future by a renewed political will to become less dependent on imported energy. Many developed countries have already made moves in this direction, though others – notably the US – have dragged their heels. Even US attitudes will change, though this may be due more to an effort to become less dependent on imported oil than to environmental concerns.

The emerging economies will become increasingly influential players in the global economy. The past decade has seen a trend towards countries shifting a much higher proportion of their foreign currency reserves into sovereign wealth funds (SWFs) in pursuit of higher returns than those offered from the official reserve holdings. Emerging Asia and oil producers are estimated to have over $3tn of funds in SWFs. Among the most prominent players are the Chinese Investment Corporation, the Russia Reserve Fund, the Abu Dhabi Investment Authority and Kuwait's Investment Authority. The investments that these funds have made in developed economies have bolstered the status of a number of emerging economies as major new power brokers in the world economy and this trend is set to continue.

The creation and growth of the SWFs and their more conservative predecessors, to which we could add the size of pension funds in the West, is really just a new manifestation of what has been a major feature of the world economy for many years – the global excess of savings over investment. This has fed both the growth of the international financial services industries, which re-cycle the various surpluses, and periodic financial crises ranging from the Latin American crisis in the 1980s, to the Asian financial crisis of the 1990s to the current US sub-prime crisis. All of these have been associated with excess liquidity and over-investment and the ongoing existence of global financial imbalances means that such crises are likely to re-occur periodically in the future despite any new onset of banking regulations. Exactly where and when, unfortunately, is impossible to say!

Shifts in global property investment

Real estate has been at the heart of recent financial events, both as original trigger (US residential sub-prime) and as transmission agent to the real economy (e.g. UK mortgage and housing market). Although, globally, the commercial real estate market had peaked before the credit crunch hit last August, conditions have been exacerbated by the liquidity crisis, re-pricing of debt and widespread deterioration in sentiment.

The problems in the debt markets are evident on a global basis but the UK and US are more highly leveraged and, as such, have been hit earlier and harder. While initially avoiding the slowdown, the investment environment in Europe and Asia has also showed signs of weakening and it is widely accepted that property prices are now weakening in most parts of the globe. The correction in market pricing has occurred most rapidly in the UK, where yields have moved out by as much as 150bps on prime properties, since their trough in April 2007, with even greater outward yield movement for secondary properties.

The speed with which values have adjusted in the UK market has attracted comment. One potential explanation is that the UK system enjoys a more realistic 'mark-to-market' approach to valuations, which allows for an obvious change in sentiment. Another possibility relates to the shifting nature of the UK investor base: the recent increase in number of retail and opportunity funds serving to dilute the more conservative behaviour of traditional, longer-term institutional investors.

Nevertheless, investment opportunities exist and are likely to grow and benefit those investors in a strong position (i.e. equity-financed) to capitalise. Arguably, investment opportunities already exist in indirect markets (derivatives, debt) and they are likely to grow in the direct market in the near term as risk is re-priced.

Despite the global economic uncertainty, the globalisation of real estate remains a key trend. While domestic investment volumes across the world remained steady in 2007, on a par with 2006 volumes, cross-border investment increased as did inter-regional flows. Despite a number of factors that will constrain investment volumes in the near term, we do not expect a strategic and planned withdrawal of capital from real estate. Nor do we expect investors to adjust significantly their allocations to the asset class.

In fact, the enduring popularity of real estate as an asset class was highlighted in the first major survey of pension fund intentions since the market sell-off accelerated in September. The report produced by finance revealed that 74% of respondents expect to increase or maintain their asset allocation to property over the next three years.[1]

Our long-term outlook for the sector remains positive. Real estate's stable income component is positive when investors are insecure about total returns. In periods of uncertainty, it is often wise to revisit the fundamentals. Based on the growing credibility of real estate as an investible asset class, we now turn our attention to the current context for global real estate capital flows.

Capital flows

Paul W. Marcuse, Head of Global Real Estate, UBS Global Asset Management

Given the unprecedented events unravelling in the global economy it would be short-sighted to discuss capital flows in real estate as distinct from wider deleveraging in the financial sector. The key factor behind the fall in global investment volumes in 2008 (see Figure 1) has been the credit crunch. Debt financing for real estate has become more expensive and significantly more restricted. The commercial mortgage-backed securities (CMBS) market has all but shut down. Spreads have increased to new record highs and much stricter terms including significantly lower loan-to-value ratios are being required of all lenders. As such, many of the leveraged investors have had to withdraw from the market or, in some instances, to reduce their leverage, become sellers of property. Large liquid retail funds, as are common in the UK, have come under particular pressure caused by investor withdrawals and have undoubtedly been a factor behind forced sales, speeding the market's adjustment.

Elisabeth Troni, Global Real Estate Economist, UBS Global Asset Management

This squeeze on credit has had an immediate knock-on effect to capital flows. The US sub-prime market has resulted in a general loss of confidence in asset-backed securities, a collapse in debt markets and unprecedented liquidity problems in the interbank markets. Balance sheet lenders have also found it difficult to distribute or syndicate their exposure and have seen their sources of funding become scarce due to market uncertainty. This, on top of declining property values and a general re-rating of credit risk in the real estate sector, has resulted in a lack of new loans, causing a severe lack of liquidity in the marketplace, most obviously in the UK.

Figure 1: Investment volume by property type

	Volume Oct 2007-08 £bn	Change in volume Oct 2007-08 %	Q3 2008 Estimate %
Office	136.0	-65	-62
Industrial	36.5	-48	-60
Retail	67.2	-62	-59
Apartment	47.1	-49	-67
Hotel	26.5	-71	-71
Dev site	74.4	-19	-72
Total	**£387.7**		
Average		**-57%**	**-64%**

Source: Real Capital Analytics, October 2008

1 Source: Financial Times, 10 November 2008

According to DTZ's Money into Property 2008 report, global direct real estate transactions were down 50% in Q1 2008, compared to the same period in 2007 (see Figure 2). In the UK transactions stood at £7bn, 42% down on Q1 2007. The enduring disconnect in buyer/seller price expectations has left many deals on hold or deferred and suggests yield correction still has further to go in the UK and also Europe.

Yet, in spite of the upheaval in the financial system and depressed transactional volumes, capital earmarked for real estate continued to flow across the globe. According to DTZ's estimates, the value of the global real estate capital market actually rose in 2007 to reach $12tn, up 18% on the previous year. The rate of growth, however, slowed significantly from the previous year and is evidence of the sea change in the global investment market. DTZ expects a fall of 30% in 2008 to about $500bn, down 30% on 2007.

Alongside the declining growth rate is the noticeable shift of capital flows into Asia Pacific. Despite the downturn in some of the major real estate markets, and the effects of the weakening dollar, capital flows increased into the region. Japan is by far the largest market, accounting for over half of total transactions, followed by one-third of activity taking place in four markets: Australia, Hong Kong, China and Singapore.

Figure 2: Global capital flows

	Capital flows by regions		
	Asia Pacific $bn	US $bn	Europe $bn
1998	215.60	132.13	140.64
1999	112.89	221.08	188.30
2000	-181.30	162.18	184.64
2001	-147.14	165.07	163.23
2002	171.56	167.14	187.91
2003	217.60	188.53	207.25
2004	148.50	274.26	261.54
2005	80.44	407.73	322.88
2006	146.46	431.52	491.33
2007	415.88	388.73	530.39

Source: Money Into Property 2008, published by DTZ

This tallies with DTZ's Investor Intentions Survey, which reveals that 62% of respondents expected to increase funds allocated to real estate in 2008, with European and Asia Pacific investors significantly more positive than those based in the US. Overall, investors expected to increase funds allocated to global real estate by an average of 4%, and Asia Pacific investors expected to increase their allocation by 10%. The survey reveals that 56% of all respondents planned to increase exposure to Asia Pacific (against only 15% wanting to reduce it), with China remaining the primary area for investor interest, whilst there was some shift in focus away from Japan, Australia and Singapore in favour of emerging markets such as Vietnam and Indonesia.

Meanwhile, the survey shows a marked shift in sentiment towards the UK with just 44% of respondents looking to increase their exposure in 2008 compared to 80% in 2007. UK commercial property values have fallen by circa 18% year on year since September 2007. Further falls are anticipated by many, with investment returns expected to remain weak until 2010.

Given the new set of challenges, is there still a case for property? Should we expect global capital to continue flowing into real estate with many markets having registered real negative returns in 2007? The answer is yes – the case is still strong, and for the same reasons people were citing before the current credit crisis. Essentially, over the long term real estate still delivers favourable risk-adjusted returns judged against comparable asset classes. In fact, we would argue, that real estate is positioned even more favourably in times of distress when investors exhibit flight to quality tendencies and re-focus on real assets. Bricks and mortar are straightforward, tangible investments and are reassuring in times of extreme financial flux.

Real estate's track record of strong performance coupled with relatively low risk has earned the sector its way into a diversified portfolio of stocks, private equity and bonds. Using data (1971-2007) from the UK (though similar results can be demonstrated where other robust data is available), the correlation between equities and real estate was 0.2 and between gilts (i.e. UK government bonds) and real estate was 0.0 – see Figure 3. In this way, the addition of real estate can lower the volatility of a portfolio of equities and bonds and provide a higher return per unit of risk.

Figure 3: Correlations between UK real estate, equities and bonds (1971-2007)

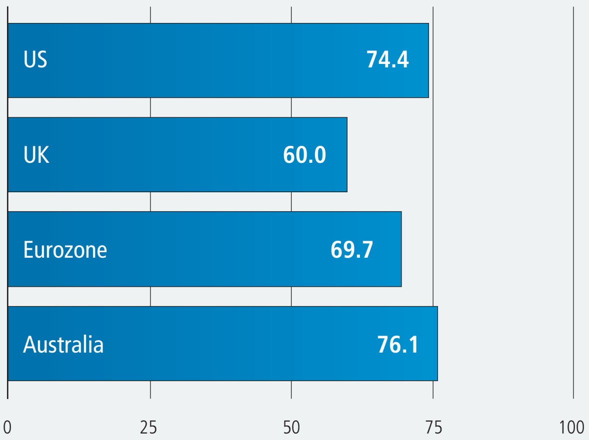
	UK property	UK equities	UK govt bonds
UK property	1.0	0.2	0.0
UK equities		1.0	0.6
UK govt bonds	0.0		1.0

Source: UBS Global Asset Management, Global Real Estate Research and Strategy

It should be noted that the level of diversification available will depend upon the route used to gain exposure to real estate. For instance, the public real estate markets are typically more correlated with the performance of the wider stock market than private, unlisted vehicles and so offer lower levels of diversification but a higher degree of liquidity.

A particular feature of real estate is the high proportion of total return which is derived from income return over the long term.

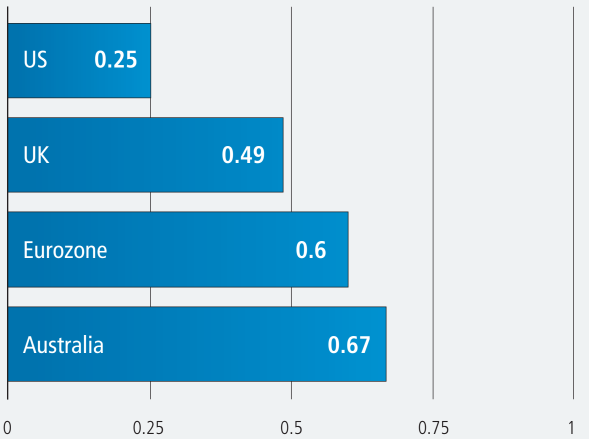
Figure 4: Proportion of income return in total return



Source: UBS Global Asset Management, Global Real Estate Research and Strategy

Note: Over the following time periods: US 1977-2007; UK 1981-2007; Eurozone 1995-2007; Australia 1985-2007

Figure 5: Correlation of capital return with GDP growth



Source: UBS Global Asset Management, Global Real Estate Research and Strategy

This is of particular benefit in today's economic climate as a focus on income is desired in times when people are concerned about total returns. Figure 4 shows the percentage of total return from income return for various markets across the globe, where sufficiently long data series are available. Investments which are less reliant on capital return are generally less volatile than those which are more reliant on capital return.

Figure 5 shows that there is a contemporaneous and positive relationship between capital return and GDP growth across the global real estate markets. As economies expand so the demand for real estate drives rent levels higher, which are partially reflected in capital returns. This is a useful basis for evaluating many emerging markets where market level data is not often as consistently available as in developed markets. With commingled funds being raised on a global scale, a diversity of metrics is crucial to identifying the relative opportunities available in the international market.

Real estate is a cyclical asset but looking at the published private real estate indices, such as those created by IPD and the National Council of Real Estate Investment Fiduciaries (NCREIF), the volatility of real estate appears relatively low compared to that of equities and bonds. However, using unadjusted historic estimates of real estate's volatility can result in exceptionally large hypothetical allocations to real estate, which should be viewed with caution. Real estate companies' securities and REITs tend to display a far higher degree of volatility than the published private real estate indices, not least because they are publicly priced. The combination of the two of them adds further strength to an asset allocation strategy, due to their differences rather than their similarities.

Historically, the orthodoxy of real estate investment has been to invest primarily in the domestic market. The starting point for those investing internationally was then to demand a risk premium over their domestic market, whether this is appropriate or not. Using this approach led some investors to accept risks that they might never take on domestically, for a sometimes small incremental return for their real estate portfolio. However, this is changing as global real estate investment is now more achievable and better understood than it has been before.

Investing globally in real estate opens up a set of opportunities at three key levels, as discussed below:

Wider opportunity set

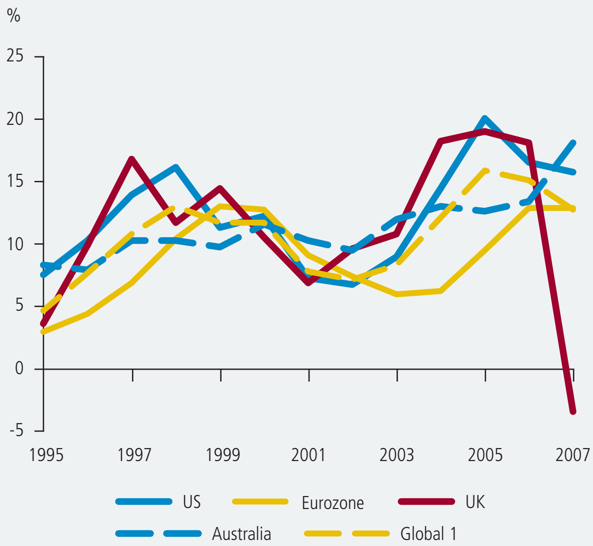
The average size of the invested real estate market across a set of 38 countries is $316bn and the total global invested stock is $12tn. It demonstrates that, on average, non-domestic real estate investment increases the potential universe size by 38 times. Clearly such an average disguises a range of outcomes where for a small domestic market such as Switzerland the benefits are far greater (63 times) than for the US (3 times).

Broadening the investment horizon for real estate investment can open up a wide set of opportunities beyond simply investing in other countries and expands the stock of properties available for investment. The most apparent of these opportunities is that, in a number of countries, institutional investment in the residential sector is not only possible but can form the main part of a country's institutional real estate market. Other such sector opportunities might be hotels, student housing and retirement homes.

Diversification

Beyond simply widening the opportunity set, investing on a global basis can provide powerful diversification benefits, as shown in Figures 6a and 6b. Whilst a global real estate cycle can still be identified, the correlation between the main regions is relatively low. It is possible that these levels of inter-regional correlations are flattered by the use of indices that are constructed by using individual real estate valuations, which are on a different basis from one another. However, there can be little doubt that investing globally in real estate reduces market risk.

Figure 6a: Total returns by region



Source: UBS Global Asset Management, Global Real Estate Research, IPD, KTI, NCREIF

Figure 6b: Correlation between regions (1998-2007)

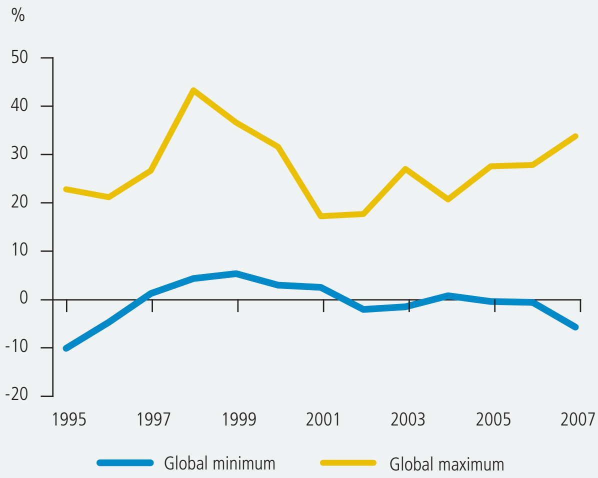
	US	Eurozone	UK	Australia
US	1.00	0.37	0.32	0.52
Eurozone		1.00	-0.21	0.26
UK			1.00	-0.41
Australia				1.00

Source: UBS Global Asset Management, Global Real Estate Research, IPD, KTI, NCREIF

Greater opportunities to enhance returns

For those seeking higher returns there is a wide range of possibilities. Figure 7 shows global minimum and maximum total returns available from a set of 82 country/sector combinations (for example, French retail and German office) since 1995. The range in 2007 approached almost 40%, which is not unusual in a historic context. However, it is not possible to switch countries and sectors as quickly as might be desired, although this may become possible over time through the use of derivatives. Picking the best performing market returns in advance is also a challenge but real estate markets appear, generally, more predictable than bond and equity markets.

Figure 7: The range of global returns available at country/sector level



Source: UBS Global Asset Management, Global Real Estate Research and Strategy

With such straightforward potential benefits to investing globally, the orthodoxy of real estate as a local investment is being increasingly challenged. But, investing globally in real estate is not without its challenges. Risk and return factors are important, as are differing lease structures and tax rates across countries. There are also risks associated with transparency, differing legal frameworks and political stability. Notwithstanding these, with a large international portfolio risks should be diversified and the benefits of an international strategy clearly outweigh the disadvantages.

Outlook for global investment

While global transaction levels are likely to remain subdued through 2009, with many economies in or verging on recession, investor interest in Asia Pacific and emerging markets should offset some waning appetite for the US and European markets. Weak occupier markets may delay the recovery in the UK and the US, with further corrections likely across Europe.

Investment trends are much more varied geographically diverse with a clear split emerging between the East and the West as well as between emerging and developed countries. According to data from Real Capital Analytics, China replaced the UK as the second most active country while Japan overtook Germany for fourth place, as at H2 2008. Combined with the growing investment in its emerging markets, Asia now accounts for a third of global property acquisitions, doubling its market share in a year.

So where does this leave investors? In the near term, the markets most likely to attract capital flows are those where debt is less of an issue and where rental fundamentals and economic growth prospects are strongest. Based on these two criteria, the Asia Pacific region looks relatively strong. Asia was the last region to suffer from the effects of the global credit crunch and with its generally strong growth story will likely be the first region to recover. Nevertheless, the global slowdown has precipitated a tightening of lending standards and interest rates have risen in many Asia Pacific markets. Furthermore, the global economic slowdown has caused investors to reassess the short to medium term growth prospects of many markets in the Asia Pacific region and raise risk premiums and required IRRs. As was witnessed in other global markets, sellers are reluctant to reduce their pricing expectations resulting in a standoff.

While the UK market, like the US, is undergoing a period of significant re-pricing it will be able to endure the adjustment period and move on relatively quickly. The extent to which the UK market recovers will depend on the debt markets, the wider economy and the relative pricing that emerges after further corrections. A significant number of bank loans are believed to be due for refinancing towards the end of the year and UK retail funds are coming under increased pressure to meet payments which could result in an increase in motivated sales. Transaction volumes are likely to pick up once forced selling accelerates. In the event that quality product is released onto the market, there is likely to be strong demand from investors with low leverage positions.

Eventually re-priced real estate in Central London should look like good value again. Today, however, compelling arguments exist that suggest UK investors should take an ambitious approach when deciding whether or not to invest overseas. Fortunately, global real estate markets are more transparent and open to cross-border capital than ever before.

Web Watch

The most popular pages this quarter:

1. Events
2. Consensus Forecast
3. Research Downloads
4. Events Downloads
5. Members Directory
6. Midlands Regional Dinner
7. Journal Downloads
8. Research Supporters
9. Annual Lunch
10. IFA Guide

www.ipf.org.uk

Price or value? Do valuations reflect the market?

Alan Gardner, Associate Director, Jones Lang LaSalle

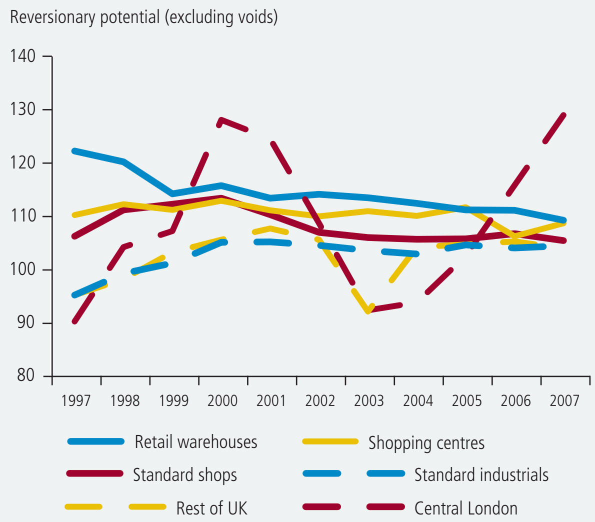
In the current market environment, any signals that can help define mispricings and act as buy or sell triggers will prove very valuable to those investors trying to time the market.

Reversionary potential

Reversionary potential is a spot measure which defines the ratio between current contracted rent and current open market rental value. Where reversionary potential equals 100, the asset is classed as rack-rented. This measure is usually considered in an individual asset context as the factors which drive the rental value of a single property are often unique. This measure can, however, be considered at an aggregated level and this can help investors determine whether a particular market is over- or under-valued at a certain point in time.

The historic reversion across several sectors is illustrated in Figure 1. The Central London office market cycle is clearly the most volatile. The relationship between rental value growth and reversionary potential for Central London offices and retail warehouses, as shown in Figures 2 and 3 respectively, is significant, with correlations of 0.46 and 0.87 respectively.

Figure 1: Reversionary potential (excluding voids)

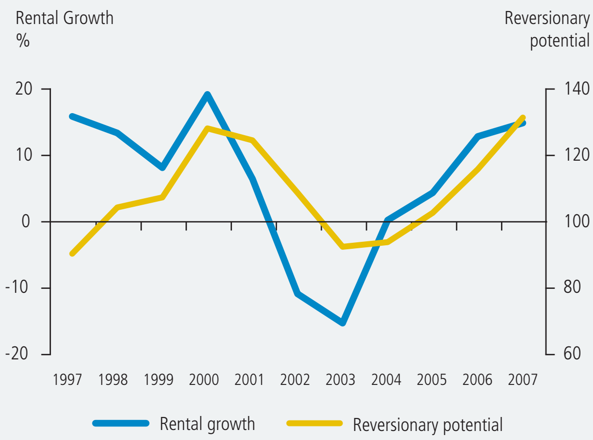


Source: Jones Lang LaSalle, IPD

At a time when rental values are weak and are falling across several sectors, the level of reversion tied up in valuations must fall. The investor will require greater compensation up front in the initial yield. This was the case in the Central London market over the last downturn (see Figure 4) and is beginning, albeit slowly, to be reflected in the IPD quarterly statistics.

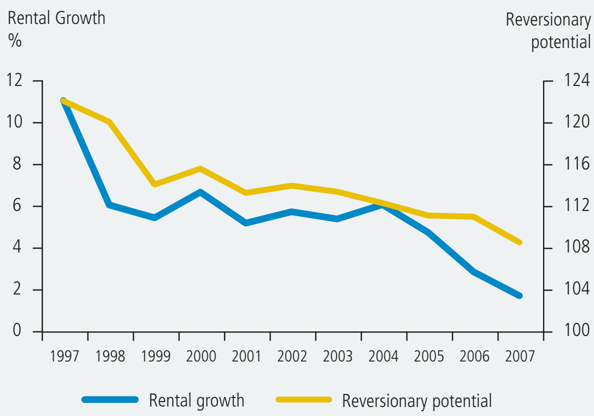
The situation, however, is slightly different with retail warehouses where the level of income return has continued to decline despite the slower level of rental growth and reversion that was recorded in recent years. Part of this can be explained by valuers being cautious as to future rental value growth (lower reversion) given the exceptional numbers generated by that sector in the past. At the same time, the income generated in terms of a cash yield continued to fall as investors pushed prices ever higher and yields lower.

Figure 2: Reversionary potential and rental growth – Central London offices



Source: Jones Lang LaSalle, IPD

Figure 3: Reversionary potential and rental growth – Retail warehouses



Source: Jones Lang LaSalle, IPD

This has started to change and the retail warehousing sector has moved significantly over the past year. The initial yield recorded in September 2008 was 5.6%, far higher than the low of 3.8% recorded in December 2006.

In other market sectors, the reversionary numbers are not tied into the rental cycle to any significant extent and are not of a

Figure 4: Reversion and income return – Central London offices:

Source: Jones Lang LaSalle, IPD

scale that can be used to identify mispricing. It should be noted, however, that all sectors record positive reversionary potential, reflecting a view that rental incomes will grow, if not by much. Given the economic prospects currently facing various occupiers, particularly in the retail sector and across financial services, this could prove over-optimistic.

The West End market will have to generate substantial income growth if it is to justify a current initial yield of 4.90%. In recent times, this has been possible – according to IPD's data, almost 20% of leases subject to new lettings at expiry across all sectors are able to achieve rental uplifts exceeding 80%. Many of these leases will be in the West End. By contrast, renewals have much less upside and are more likely to deliver increases of around 20%. These numbers must be considered in the context of approximately 20% of leases expiring each year. Put simply, landlords have to achieve strong uplifts to justify current pricing and this will be tough in today's world where occupiers call the shots.

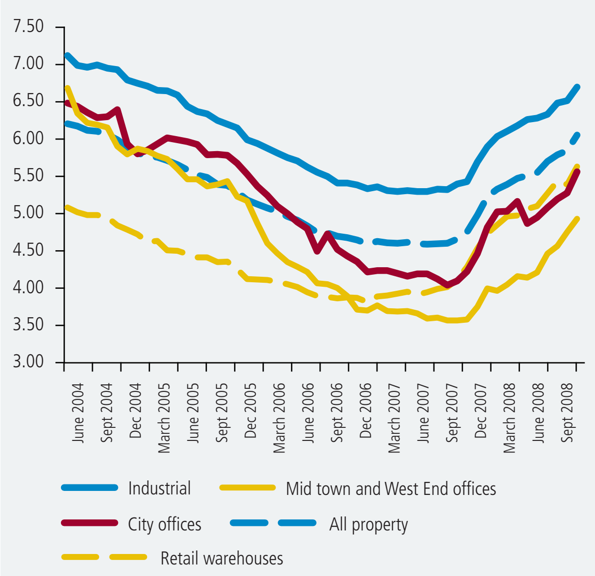
Given that office rents in the City are also falling, with current initial yields at 5.53% and equivalent yields at 7.29%, the basic cash yield looks unappealing to investors looking at the market in isolation, given that they could buy AA corporate bonds (with minimal transactions costs) at 9.7%. It should be pointed out that City yields have already risen from the low of 4.02% recorded in August 2007, highlighting the scale of correction that has already taken place.

The market adjusts – Do any sectors offer value?

The scale of the correction that has already taken place across the sectors is evident if you analyse the initial yields shown in Figure 5. Based on the valuations which construct the IPD Monthly Index, property now offers an initial yield of 6.03%, the highest since October 2004.

In the financing and economic environment of October 2004, further yield compression could be justified. The asset class offered a cash yield that exceeded the rate available on government bonds and the central London office rental cycle was picking up after struggling for three years. With the wider economy expanding, there was sufficient room for a higher level of reversion in the valuation as rental growth was starting to accelerate.

Figure 5: Initial yields – the ongoing correction

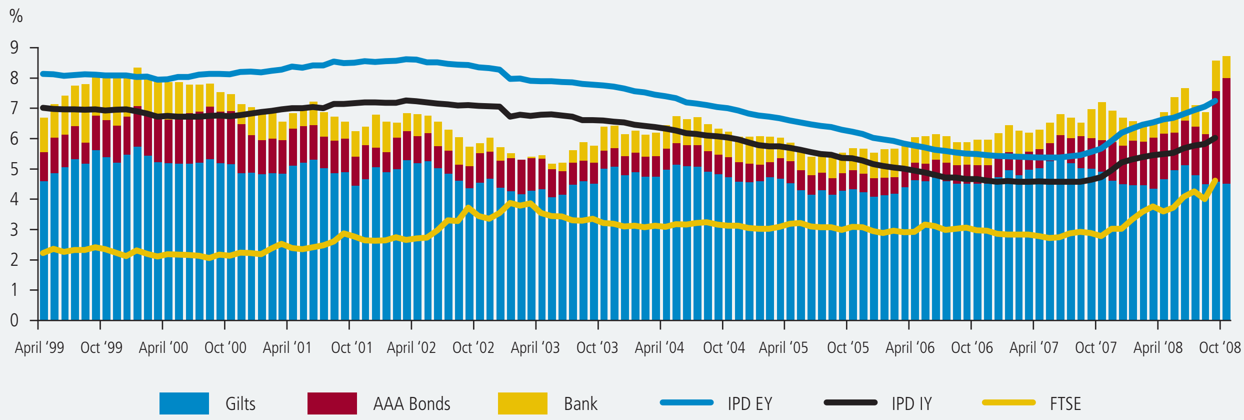


Source: Jones Lang LaSalle, IPD

This is no longer the case given that the risk premium in all asset classes has increased substantially as the credit crunch continues to filter through to asset pricing across global markets. In the UK, as already mentioned, corporate debt continues to offer a premium over and above property yields. This premium expanded rapidly in September 2008 as the banking sector imploded. In addition, banks who are extremely nervous at the scale of their exposure to property continue to demand a much higher margin over their own higher cost of capital. They have also curbed loan to value ratios as they attempt to improve their balance sheets. This makes property unattractive at the present time, as illustrated in Figure 6.

However, property yields have already moved to a point where traditional investors see no real benefit in selling unless they are forced to, either by banks trying to recoup some money, or through retail investor redemption flows. This has led to the present market stand-off where buyers and vendors expectations remain significantly different. At current valuations, it is difficult to see how the property market can generate substantial returns over 2008 and 2009. Property yields are therefore likely to rise even higher in the short term.

Figure 6: Property's price in the current investment market



Source: Jones Lang LaSalle, IPD, Thomson Datastream

Outlook

Investors looking to buy near or at the bottom of the market may find that property appears attractive relatively quickly once the bankers' settle on a 'post credit crunch' price for doing business. Direct property has proved again that the option of not having to trade in falling markets is extremely valuable, compared to other asset classes which are marked to market daily. In this context, we expect current owners to continue to hold onto assets where they can so they do not have to crystallise losses. Investment returns, assuming a reasonable economic recovery takes place towards the end of 2009 or possibly in 2010, start to look attractive again. If investors are pocketing initial yields well above 6%, they could look very healthy.

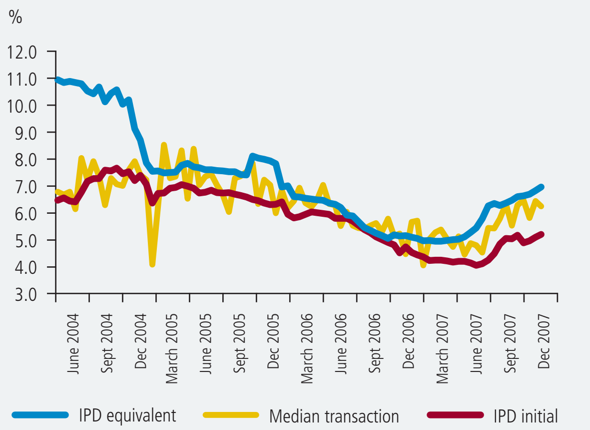
With the weaker state of the economy putting tenants in a stronger negotiating position, investors are more likely to look at higher initial yields in order to achieve a sufficient return. If they cannot achieve income growth, the only option is to reduce the valuation and squeeze down the reversion. This happened in the Central London office market over 2001 to 2004 without a major hit on yields as property remained largely self-financing in terms of price allowing investors to profit even as rents were falling. This is not possible in the current market.

This represents a real challenge for valuers who have to appraise on the basis of a fair price between both buyer and seller. There is a dearth of transactions that can accurately be described as representing genuine fair value for both parties and the market stand-off is likely to persist in the short term.

Direct property owners will be concentrating on collecting as much rent as possible and looking for opportunities where they can find them. As a result, the relationship between a daily mark-to-market price in the derivatives market and what the valuation-based index actually delivers is likely to remain detached.

This can be demonstrated by looking at the relationship between median transaction prices and the smoothed valuation yields for

Figure 7: City office yields



Source: Jones Lang LaSalle, IPD

the City office market. Traded prices also move away from valuation initial yields, as shown in Figure 7. These are prices that are more acceptable to buyers but vendors will not accept, unless they have no choice.

There is far less information for valuers to analyse and they have therefore had to try and estimate the extent of the price correction that has taken place, whilst still holding a line between a fair price for buyers and seller. Given that this price does not really exist at the moment, valuation based indices are likely to continue being less severe with pricing property than the analysis of the limited number of transactions would suggest.

This has pricing implications for other indirect property investment vehicles, where market sentiment and liquidity have a much greater influence on price. As well as focusing on timing the market, clever investors will also try and benefit from relative pricing differentials across the property asset markets.

CMBS market under stress
Finding a consistent approach for an inconsistent sector

Hans Vrensen, CFA
Head of European Securitisation Research, Barclays Capital

Mark Nichol, CMBS Analyst, Barclays Capital

This article provides a brief update of the CMBS market and then present three different stress-testing scenarios for CMBS deals – to try and determine how bad things might get. The wide range of results from using the stress tests on three representative CMBS transactions underlines the view that CMBS deals are unique and require credit analysis customised to each deal's characteristics. Generalisations along vintage, LTV, geography or property types might be interesting, but are unlikely to provide the correct answers for all individual deals.

Current European CMBS market

Placing the impact of the US sub-prime crisis on the wider European securitisation market into its proper context, we note a number of things. Foremost is that the impact has come through the liability side, as global bond investors suffering from mark-to-market losses on their US sub-prime and other asset-backed securities (ABS) positions sold high quality, liquid European ABS. This was not limited to selling by structured investment vehicles (SIVs) that were forced to do so by structural features and the seizing up of their commercial paper funding. Other investors, like fund managers, also sold to facilitate calls for cash redemptions from their ultimate retail or institutional investors.

Rational investors at that point favoured selling assets with either little or no loss (i.e. European ABS) when compared with assets with a high potential loss (i.e. US sub-prime). Of course, by selling European ABS in the secondary market, spreads widened, increasingly leading to mark-to-market losses. At the same time however, the asset side (or the underlying loan pool assets) was still performing well, with limited or no loan level defaults and no note-level losses. However, problems with monolines and uncertainty around ratings have helped in further advancing the negative sentiment in the broader bond markets.

European ABS have been largely funded by central banks' liquidity facilities over the past year. As secondary spreads widened, primary issuance stopped. Asset spreads no longer outstripped potential liability spreads, making securitisation inefficient for banks and other originators. To fill the funding gap created by the lack of further ABS issuance banks turned to the central banks' liquidity facilities. Instead of issuing bonds to investors, banks issued rated ABS bonds that were retained and posted as collateral with the European Central Bank (ECB) or Bank of England (BoE). This issuance should have cleared a large part of the pipeline assets, which banks originated with the intent of exiting via securitisation. We estimate that the use of ABS as collateral under the key European central banks' liquidity facilities has grown to around €600bn by Q3 2008. Despite the haircuts and other requirements, funding costs through central banks' liquidity has been more attractive than a return to primary issuance.

As both US and European banks have suffered from large write-downs in their ABS and structured product exposures over the last year, their capital requirements have increased at the same time. Most of these needs have so far been met by sovereign wealth funds and others. As a result of the well publicised failures and problems in the banking sector, lending criteria have become stricter since mid-2007. These changes have been highlighted in both central bank surveys, as well as sector-specific research. As the banks' own funding needs increase over the next year or so owing to the central banks tightening of liquidity facilities, it would be unreasonable to expect a short-term easing of banks' own lending criteria as they will be focused on maintaining their own liquidity and solvency.

Not dissimilar to the US, the UK housing market was partially driven by the previously wide availability of debt finance. As lending criteria tightened, we have now seen a slowdown in UK house prices turn into a significant decline. Other European markets, such as Spain and Ireland, are following this pattern as well. Cuts in home building and a slowdown in consumer spending have also lead to increases in unemployment and a slowdown in economic growth. This deterioration in economic fundamentals has now started to result in increases in arrears, defaults and losses in loan pools. The outlook in the short term is not positive and further decline in asset pool performance for European ABS transactions should be expected.

In addition to tighter lending criteria and a worsening fundamental outlook, there are other factors affecting the market. Uncertainty around ratings and rating agency behaviour poses a problem for many banks and institutional investors that are either unable, or self- or reserve-restricted from holding anything other than AAA-rated bonds. The regulatory pressure on rating agencies to consider new rating notations has further strengthened this uncertainty. As a result of these factors, most European ABS investors have stopped re-investing redemptions on their existing ABS holdings, which has limited trading volumes in the secondary market. On the other hand, many US-based hedge funds, high yield investors and some newly launched distressed debt and bond funds are more actively looking at European ABS.

It is our belief that investors will ultimately be attracted to the good relative value offered in the ABS markets, once the current level of uncertainty surrounding performance and ratings has been resolved. In our view, it is not so much a question of if, but more of when. Thus, when either existing or new investors return to the secondary European ABS market, we expect they will focus on the more liquid segments first. This implies that a recovery in the ABS bond markets is most likely to be at AAA and in the largest prime residential mortgage-backed securities (RMBS) segments, such as UK, Spanish and Dutch prime. This will be followed by recovery in less liquid segments of the market later. Also, global investors are likely to focus on US markets first, as the dislocation there has been more significant than in Europe. Although we do not want to overstate the extent to which global investors drive regional ABS markets, it does drive marginal new investors, such as hedge funds. Buying large portfolios of either loans or bonds from distressed US investment banks is likely to be more profitable in the short term than buying from less distressed and more universal European banks. On the other hand, given current trading volumes in secondary, we expect that a small number of new active investors could easily change the widening bias of European ABS spreads. In short, we expect a staged and sequenced return of markets, which once underway could be relatively rapid, especially, as many investors are long cash and are attempting to time their return.

Having provided this broader context for the European CMBS market, the impact from US sub-prime was not dissimilar to other sub-sectors. Secondary spreads widened and primary issuance ceased. However, there are couple of differences between CMBS and other ABS sectors as well:

- CMBS has been less liquid in the secondary market than bonds in most other ABS sub-sectors, as most investors find it to be less transparent, less standardised and more credit intensive. Apart from wider bid-ask spreads than in other sub-sectors, spreads on European CMBS have been wider than most other sub-sectors, other than UK non-conforming RMBS: and
- There have only been a limited number of retained CMBS bond issuances. This could be partly because CMBS bonds are not allowed to be posted as collateral under the BoE liquidity facilities, making the pipeline problem for banks' commercial mortgages more severe than in other sub-sectors. The ECB does not exclude CMBS explicitly, but only few CMBS bonds appear in its list of eligible ABS collateral.

Fundamentals have also started to show highly publicised negative effects on a number of deals that seem to centre around:

- Borrowers forced into administration, as in the case of Level One (Titan Europe 2006-5, Cornerstone Titan 2007-1, Titan Europe 2007-2 and Talisman 7) and Dawnay Day (DECO 7-Pan Europe 2);
- LTV covenant breaches – leading to informal noteholder meetings e.g. EPIC (Industrious), REC 5 Plantation Place and Gemini (Eclipse 2006-3);
- Single tenants forced into administration, as with ILVA and LESG e.g. DECO 2205-UK1 and Titan Europe 2007-3; and
- Refinancing problems – as in the case of Titan Europe 2006-4 FS.

Stress-testing approach

To address a key question from investors in the current environment, we try to determine how bad things might get by stress testing individual deals, using a consistent approach in a sector with widely differing deals. This section outlines an appropriate stress framework that takes into account the non-granularity and complexity of European CMBS deals.

In our view, stress testing CMBS at the note level requires both forecasts for recoveries and expected losses at the loan level, as well as loss allocation to the notes. Given the lack of granularity in most European CMBS loan pools, there are considerable differences between the relatively small number of loans backing European CMBS deals. Consequently, we do not think it appropriate to apply uniform default rate and loss severity assumptions across all loans in a deal, like in RMBS or US CMBS transactions, as such a general approach is likely to produce misleading results. To incorporate all relevant drivers into our credit analysis, we have developed a sequenced, six-step approach, briefly summarised as follows:

Step 1: Forecasts for the UK economy, which feed into

Step 2: Projections of rental and value growth for commercial property sectors, which drive

Step 3: Property rents and values securing the loans, which determine

Step 4: Coverage and LTV levels on the loan-level, providing

Step 5: Issuer level cash flows and structural triggers, which ultimately produce

Step 6: Interest and principal payments and weighted average loss severity (WALS) for each tranche

In addition, we have three different stress tests, which feed through the six-step approach. The base case and recession case are both determined by different economic stress scenarios. We also have a worst case, which is the same as the recession stress, but assumes more assertive servicer or trustee behaviour in proactively testing and enforcing potential covenant breaches. This triggers an earlier enforcement and possibly bigger loss to junior tranches compared to less assertive servicer or trustee actions.

Highlighted below are some of our key assumptions for each step.

Step 1: Our economic stress scenarios (as set out in Figure 1) are based on a consensus between our UK economists and our securitisation analysts. We also received feedback from Property Market Analysis (PMA).

Step 2: Based on our stressed economic inputs, we produced forecasts for each property sub-sector's rental income and capital values for each scenario. To put our forecasts into perspective, we compared them to the worst-ever experience for UK commercial property (see Figure 2).

Figure 1: Key economic stress inputs for base case and recession scenarios

	GDP % pa	Household spending services output % pa	Financial & business % pa	CPI % pa	Base rate % as at Q4	Employment growth % pa
Base case						
2008	1.4	1.7	1.8	3.6	5.00	1.0
2009	0.9	-1.4	1.5	3.2	4.00	-0.6
2010	1.5	0.5	2.7	1.9	4.00	-0.5
Recession						
2008	0.6	1.3	1.6	3.6	4.75	0.4
2009	-1.1	-2.2	-0.4	1.7	3.50	-0.6
2010	1.0	1.1	2.1	1.5	3.00	-0.5

Source: PMA, Barclays Capital

Figure 2: Sector inputs for base case and recession scenarios

	UK offices %	London offices %	UK retail %	UK shopping centres %	UK industrial %
Capital value growth					
Historical worst	-36.6	-54.5	-17.1	-20.8	-18.7
Base case	-25.0	-40.5	-23.7	-21.6	-28.0
Recession	-44.1	-57.2	-33.5	-29.5	-48.4
Rental growth					
Historical worst	-37.8	-58.6	-6.4	-5.1	-22.1
Base case	-11.1	-30.6	-0.8	-0.6	-11.8
Recession	-21.2	-39.7	-2.3	-2.1	-21.6

Note: The 'historical worst' figures are the largest cumulative peak-to-trough decline in the IPD data series from 1988-2007. In all cases the worst-ever capital value decline occurred over the 1990-93 period

Source: Barclays Capital, IPD, PMA.

Step 3: With respect to tenants and leases, we make the following assumptions:

- When a lease expires: under the base case, the tenant renews at then ERV but receives a rent-free period of 12 months; under the recession scenario, the space is vacated, re-let 24 months later at then ERV but generates no rental income for an additional 12-month free rent period.
- For break options: the base case scenario assumes that the option to break is not exercised; the recession scenario assumes that it is.
- To deal with potential tenant defaults, we assume that investment grade (IG) tenants do not default under either scenario. Conversely, we do not give any credit to non-IG tenants.

Step 4: Having generated forecasts for both rental income and capital values, we feed them into our loan level analysis, the objectives of which are:

- To determine if and when a loan might default (default probability)
- To estimate the loss on the loan once the collateral is sold (loss severity)

We expect rental income to be relatively stable in UK commercial property compared to capital values. Therefore, we expect to see more breaches of LTV covenants than interest cover ratio (ICR) or debt service coverage ratio (DSCR) covenants. To date, however, we suspect that many LTV covenant breaches have gone unrecognised because new property valuations have not been conducted since loan origination and are left to the servicer's discretion. Our worst-case scenario assumes that servicers will aggressively test loan covenants and enforce immediately upon any breach. We would expect such aggressive servicing to exacerbate loan level losses as forced property sales would be made during the market downturn rather than the recovery.

Finally, we also assume that the maximum amount available for refinancing in 2008 will be a LTV of 70%, increasing to 75% in 2009, 80% in 2010 and 85% thereafter. We calculate the sale price in the case of default based on our forecast of the property's capital value, less a forced sale discount of 10% under our base case and 20% under our recession and worst-case scenarios. We also reduce the sale proceeds by a further 7% to reflect the associated legal and selling costs under all scenarios.

Step 5: We combine our individual loan cash flows for the entire collateral pool and apply it to the liability side. The asset pool cash flows are based on our built-up default and severity assumptions, as described above. The aggregate loan pool payments are received by the issuer and allocated to the notes according to the prevailing priority of payments or waterfall. There is considerable variation in pre and post enforcement note waterfalls among UK CMBS structures, even within the same conduit programme, complicating cash-flow modelling. Fortunately, various third-party providers such as Trepp LLC, ABSxchange and Intex have created bespoke models for UK CMBS and other ABS products.

Step 6: the issuer cash flows are allocated among the bond tranches. Principal losses and weighted average lives (WAL) are calculated, which enable the bonds to be priced.

To illustrate this process, we apply our stress methodology to three representative UK CMBS transactions (Figure 3).

This wide range of results reinforces our view that UK CMBS deals are unique and require credit analysis customised to each deal's characteristics. Generalisations along vintage, LTV, geography or property types might be interesting, but are unlikely to produce appropriate answers for all individual deals.

Loan defaults at maturity increase note WALs, including potentially the senior-most tranche. Based on our forecasts, most LTV covenants are to likely be breached under both our recession and worst-case scenarios. Early loan enforcement can shorten WALs at the expense of higher losses to the junior tranches, as shown in our worst-case scenario.

Finally, the severity of losses suffered in the three transactions we modelled do not suggest to us that UK CMBS is likely to suffer losses comparable to the US subprime sector, even under our worst case scenario. Indeed, losses to triple-A rated classes are likely to be limited, in our view.

Figure 3: Selected UK CMBS transactions for stress testing

Year issued	Transaction name	No. loans/ properties/tenants	Originating bank(s)	Amount outstanding
2005	Deco 5 – UK Large Loan 1 plc	1/3/11	Deutsche Bank	£282,100,000
2006	Cornerstone Titan 2006-1 plc	9/35/166	Credit Suisse/Capmark	£532,493,560
2007	Epic (Culzean) plc	4/17/256	The Royal Bank of Scotland	£481,832,027

Source: Bloomberg, Barclays Capital

For the issuer level and note-level cash flows we used models built by the third-party provider, Trepp LLC. For these three transactions Trepp tried out its models with the underwriters at issuance, which bolsters our confidence in its results. Specifically, we used Trepp's 'loan override' function to enter our own loan-level cash flow forecasts of default and recovery. Based on our loan-level cash flow, the Trepp models produced note-level results. The key note-level results we produce are principal loss, expressed as a percentage of the current tranche balance and WAL. We have also made a number of transaction-specific assumptions, which are beyond the scope of this article.

The stress-testing results varied widely between transactions, as follows:

- Cornerstone Titan 2006-1 plc suffered losses up to the AA/A+ rated tranche.
- Epic (Culzean) plc only suffered a partial loss to its lowest-rated tranche BBB/BBB- .
- Deco 5 – UK Large Loan 1 plc did not suffer any losses.

Trying to keep insurance in focus

Bill Gloyn, Chairman Real Estate Europe, Aon Mergers & Acquisitions Group and President, City Property Association

The events of mid-September involving AIG brought the vulnerability of the insurance market into sharp focus. Admittedly, the circumstances of that particular company's involvement in some quasi-financial instruments may not be common to all insurers, but the aftershock of its financial difficulties was certainly felt globally. Perhaps even more so by those senior people for whom insurance is generally off the radar, because of the widespread involvement of AIG in Directors' and Officers (D&O) and other corporate liability policies. The spectre of D&O insurance protection disappearing, especially in current economic circumstances, certainly put insurance way up the priority list for those personally at risk.

And there it should stay, for many reasons. When I wrote in the April edition about the threat to flood insurance caused by last years extensive damage, which cost the insurance industry £3bn, it was before the official review of those events by Sir Michael Pitt had been published. It was also before the Association of British Insurers (ABI) had issued its revised Statement of Principles – the agreement with the Government to maintain insurance, subject to certain conditions.

Both are now with us and careful scrutiny does not give complete comfort as to the future of flood insurance in high risk areas and the likely action that the Government will be taking to persuade insurers that the risk is being managed – at least by them.

Sir Michael Pitt had an almost impossible task. On one hand he was expected to draw lessons from the 2007 floods with a view to improving the way that any future events may be handled and protected against. However, on the other hand, he freely admitted that the biggest single issue – how much should be spent on funding flood risk management – was outside the scope of his brief. In economic terms, he noted that "Every £1 spent on protection reduces the cost of repairs by up to £6, on average" and also that "Capital investment in flood risk management gives an average return of around 27% per annum compared with around 10-12% per annum for road and rail capital schemes". That is surely enough justification for increasing expenditure even without the non-financial aspects of the social benefits to individuals, businesses and communities of avoiding future damage.

With a, fortunately smaller, repeat of the 2007 disaster occurring this summer, it is hardly surprising that the revised Statement of Principles, trumpeted as a triumph by DEFRA when published in July, is not quite so comforting as the spin would lead one to believe.

On the positive side, insurers have again kept faith with policyholders and agreed to maintain flood insurance in general. However, this time the Statement has a finite life; it will definitely end in 2013, five years time, by which time the ABI expects the Government to have resolved the situation. Insurers consider, that without that deadline, the market will otherwise become distorted by the expectation that action will be taken without the delivery actually taking place – too often the experience in the past.

Again, the Statement does not apply to anything other than small business and residential insurance; it is subject to an annual review and in particular is conditional upon there being no significant external shock, such as the withdrawal of flood reinsurance. Finally, of note, it will not apply to any property built after 1 January 2009, although the ABI is due to issue some guidance to developers on flood protections that they are looking for in future projects. That, although aimed at residential property, will no doubt inform the opinion of underwriters in respect of commercial developments.

Although continuing to offer flood cover to properties at significant risk, providing the Environment Agency has announced plans to reduce that risk within five years, the Statement no longer gives any commitment to maintain cover in respect of high risk properties which fall outside that definition. For them, as for commercial property, the free market must operate.

We must wait to see what action flows from both the Government undertakings in the Statement and post the Pitt Review. A detailed response to the latter was due in the Autumn. In answer to a parliamentary question on 6 November, Hilary Benn, Secretary of State for DEFRA, stated that it was due to be published in "the not too distant future". New legislation is expected in Spring 2009 together with the unveiling of a new long-term investment strategy. It remains to be seen what all those will deliver but one thing is certain, insurers have signalled their intention to treat flood insurance more commercially in future. The current state of the global economy is not likely to dissuade them from taking a hard line if the undertakings given by Government are not honoured. The insurance market has to consider its shareholders, and the delivery of investment returns is conditional on underwriting profitable business.

Always look on the bright side of life

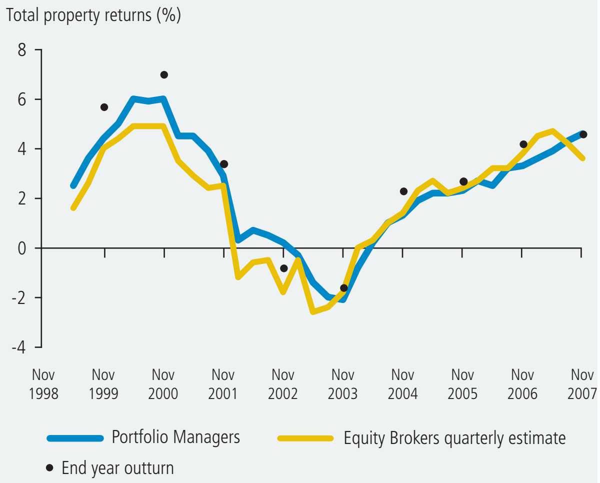
Gerry Blundell, European Director of Strategy and Research, LaSalle Investment Management

Much has been written on behavioural biases in forecasting, especially on the tendency of forecasters to huddle together. They share common data and very similar techniques, so perhaps it's not surprising that similar results are produced. Also there may be significant perceived risk in being both different and wrong.

But are real estate forecasters so risk averse? This article compares the IPF's consensus forecasts of rental growth by industry specialists (portfolio managers) and 'outsiders' – equity brokers against actual outturn as recorded by the IPD for the 1998-2007 period. It also looks at equity houses' accuracy in forecasting equity earnings growth.

The analysis suggests that there is behavioural bias in forecasting. It seems that forecasts underestimate the volatility of both return and rental series and forecasters have an aversion about forecasting negatives in their own asset class.

Figure 1: Consensus forecasts of rental growth

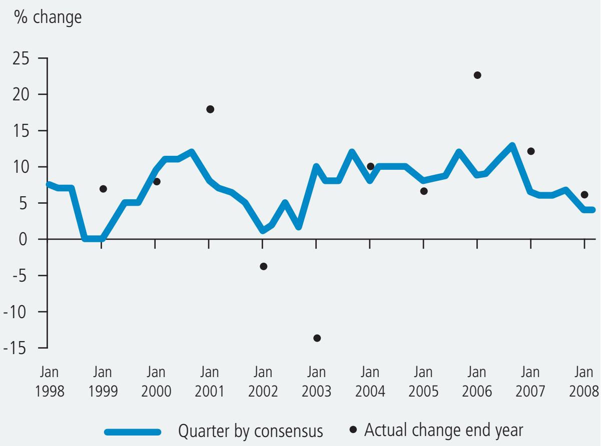


Source: IPF

Figure 1 looks at rental growth forecasts (consensus mean) by fund managers and equity brokers. The solid blue and yellow lines are quarterly forecasts of rental growth over the same calendar year from the IPF Consensus forecasts and the black dot is the outturn. The graph shows property fund managers underestimated rental growth 1999-2001, missed the negative outturn in 2002, underestimated recovery in 2004-07 and finally got it right in November 2007. As a result, I conclude forecasts underestimate future volatility which may then explain the divergence between the consensus total return and the implied returns from the derivatives market. It also suggests that risk analysis based on the consensus forecast may be under estimated. Since the end of 2007 consensus forecasts have corrected slowly downwards.

We see a better predictive performance on rents from the equity brokers, albeit a smaller group. Like fund managers, they underestimate the upside but they were better predictors of the 2002 negative outturn and, interestingly, they went negative in 2008, earlier than real estate managers (not shown on the graph).

Figure 2: Equity brokers' UK equity earnings forecast



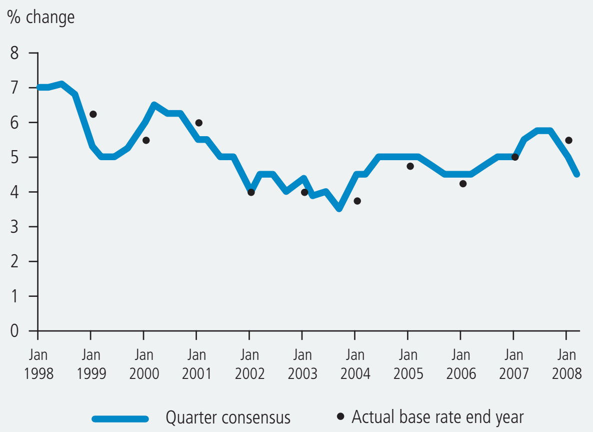
Source: Legal & General

Are we seeing a reluctance to report bad news? Figure 2 takes this further by looking at brokers' consensus forecasts of equity (FTSE 100) earnings growth 1998-2007 – these were available monthly from Legal & General – for simplicity half yearly forecasts are shown. The graph confirms the hypothesis. Consensus earnings forecasts are without exception in positive space over the 10-year period despite negative outturns in 2001 and 2002. Even after 2001 they remained optimistic. It took till 2003 for the tide to turn and then the earnings forecasts remained over optimistic till the unexpected spike in 2005, which of course they failed to predict.

Equity brokers are much better at predicting the more value neutral base rates (Figure 3). The average tracking error is much lower than earnings forecasts and significantly errors are both negative and positive implying less behavioural bias. Perhaps the existence of a mature derivatives market for interest rates helps guide them. In which case, there is hope for property forecasters, provided they can calculate implied returns!

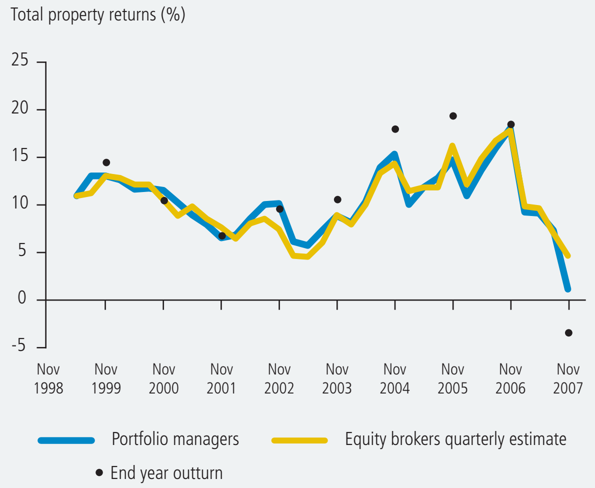
Figure 4 looks at total returns to the IPD 1999-2007 from IPF consensus data. Property managers underestimated returns in 1999, 2003, 2004, 2005, and 2006. Both they and the brokers failed to call the negative outturn of 2007. The interesting period here is 2000-02 when both groups were pretty close although fund managers were predictably more optimistic overall. This was a period when yields hardly moved (+10bps, +20bps,

Figure 3: Equity brokers' forecasts of end year base rate



Source: Legal & General Fundamentals

Figure 4: Consensus forecasts of total returns



Source: IPF

-20bps). Later on in 2003-06 they fell (-30bps, -70bps, -60bps, -60bps). It seems that both forecasting groups failed to anticipate the full extent of yield compression, even in its fourth year, hence leading to successive underestimates of return. Of course in 2007 the reverse happened.

This would imply that there is more error associated with consensus yield forecasts than rental ones. Looking at IPD data one finds that, of the three components of return over the long run, yield shift has delivered virtually no return and at considerable volatility. Perhaps there might be demand for a derivative to hedge yield shift as it seems to be a major cause of forecasting error and a considerable source of volatility that over the long run goes unrewarded.

On the basis of past behaviour we can expect the IPF Consensus forecasts to move further into negative space through 2008 led by the equity brokers. Eventually when an inflection point is reached at the bottom of the cycle it may well be an unexpected fall in yields that starts the process, followed by a slow revival in rental growth expectations that underestimates the actual strength of rental recovery.

UK Consensus forecasts November 2008

The Q4 2008 IPF Consensus Forecast reports further downward adjustments in all contributor forecasts for all sectors. All Property total return for 2008 is forecast here at -16.8% which does not look unreasonable against the IPD monthly total return figure of -14.4% to end of October. This substantial downward shift over the last three months has been driven by both falling capital and rental value growth forecasts.

The prospects for 2009 have worsened further with total return for all sectors now forecast as negative[1]. Where 12 months ago 2009 was expected to be the year of recovery it is now expected to mark the bottom of the market. Furthermore, the bottom of the market is now forecast to be much lower than predicted three months ago.

The 2010 total return forecasts have inevitably been adjusted in line with the significantly poorer prospects for 2009. Whilst 2010 is expected to see positive total returns in each sector, rental value growth remains negative across all sectors. Capital values are also forecast to still be falling in all sectors other than standard shops and shopping centres, albeit less dramatically.

These downward revisions to the forecasts were inevitable in light of sharp reductions in GDP and employment reported in the last three months. The 0.5%[2] fall in GDP reported for Q3 2008 to September marked the first contraction of the economy, as opposed to reduction in level of growth, since the recession of the early 1990's. The HM Treasury[3] consensus forecast of GDP for 2009 is now -1.1%. The last time UK GDP contracted at this rate was 1990. The slow down of the early 2000's saw GDP fall to below 1%, but it did not turn negative.

The key sectors contributing to this reduction in overall growth were construction, where output fell by 0.8%, production where manufacturing fell by 1%, and services. Business services and finance were big contributors to the deceleration in service sector growth as were distribution, hotels and restaurants. Two sectors showed positive growth: Government and other services and Agriculture forestry and fishing.

The downward trend in employment is continuing with the claimant count rising by 36,500 to 980,900 at the end of October. The unemployment rate has risen to 5.8% in Q3, a 0.4% increase on the Q2 figure. Earnings growth excluding bonuses was stable at 3.6%, substantially below current inflation levels, suggesting a real reduction in earnings over the course of the year. The only thing rising is the average number of hours worked per week by those still in employment.

The weaker employment figures and relatively high level of inflation have generated a reduction in the level of retail sales. In August and September total sales volume fell by 0.4% with non-food stores being worst affected. Non-store retailing and repairs rose again, by 12% over the three months to September.

The biggest change over the last quarter has been in the prospects for inflation and hence interest rates. No longer struggling with rising inflation, the spectre of potential deflation has now arisen as output, employment and spending have all fallen. In a matter of weeks we have moved from interest rates cuts being unlikely to seeing the most substantial cuts in a generation. Whilst the cuts were welcome the rapid change of direction illustrates the unpredictable state of the economy which is inevitably unsettling for the markets.

Key points

The consensus All Property total return forecast for 2008 has fallen sharply again moving from -10.6% down to -16.8%. The 2009 figure has turned negative for the first time.

- The unusual level of market uncertainty coupled with weakening economic data has seen substantial reductions in all three elements of the 2008 all property forecasts. The 2008 forecast spreads have narrowed as the year end approaches, albeit with one or two outliers.
- Perhaps the more significant change is the sharp reduction in forecast total return for 2009. This has fallen from 0.3% to -5.3% this quarter. The outlook for 2009 has shifted over the course of 12 months from being the expected year of recovery to being expected to mark the bottom of the downturn
- The forecasts for 2010 have also been revised downwards. Whilst 2009 is expected to mark an increasingly low trough in the market, the recovery forecast for 2010 is now looking more sluggish. Total return remains positive for 2010 but against a backdrop of negative capital value and rental value growth figures.

Rental and capital value growth forecasts have been revised downwards for all sectors for all years reported. City and West End office markets are forecast negative total returns for the 5 years from 2008 to 2012.

- Rental value growth forecasts for each sector have been reduced for 2009 with West End offices showing the sharpest fall. There appears to be less confidence now that the naturally restricted supply of space in the West End will support this market.
- Capital value growth forecasts have fallen sharply. All sectors have seen substantial downward revisions for 2008 as market conditions have worsened amid economic uncertainty and the extremely limited supply of debt.
- The office sector remains the worst effected with capital and rental value growth moving down again. The 5-year view shows barely positive total return forecasts for the sector.
- All three retail subsectors have suffered significant falls in capital value growth forecasts for 2008 and 2009. The prospect of lower interest rates has failed to make much impression on the outlook for these markets. Retail warehousing is expected to be the worst performing retail sector over the full forecast period.

1 All the forecasts were produced in either October or November, i.e. post the banking crisis and at least one interest rate reduction.

2 Economic statistics sourced from the NSO at www.statistics.gov.uk

3 Source: HM Treasury, Forecasts for the UK Economy, November 2008

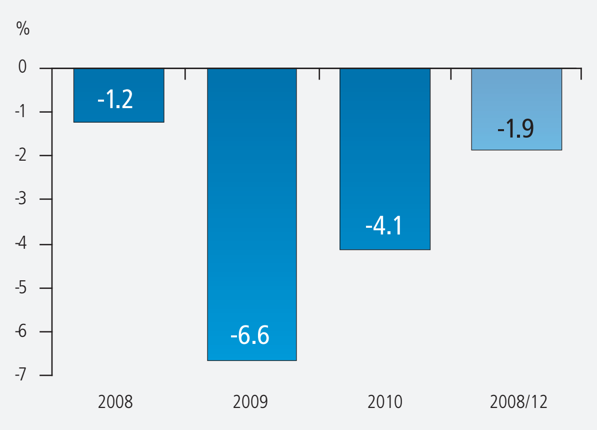
- 2009 is looking particularly bleak overall. During the three months since August the total return figures have moved from positive in each sector except offices, to forecasting substantially negative total returns for all sectors reported here.
- 2010 remains the year of recovery but from a deeper trough than previously expected. This has inevitably lowered expectations of the speed of recovery and further reduced the expected 5-year performance figures for each sector. West End and City offices are now expected to produce negative returns over the 2008 – 2012 period.

All Property rental value growth forecasts

The All Property rental value growth forecasts have fallen substantially this quarter. The sharp readjustment for 2009 seen last quarter had been repeated with a substantial mismatch between occupier demand and supply of space expected.

The forecast for 2010 has also been substantially reduced as economic uncertainty deepens.

Figure 1: All Property rental value growth forecasts



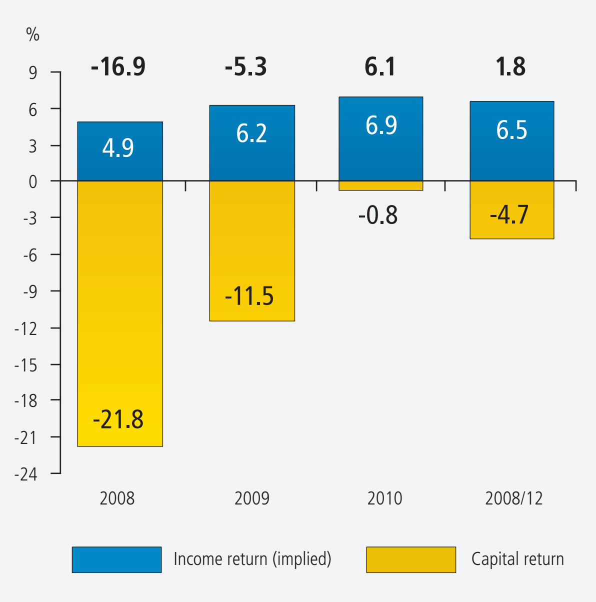
All Property total return forecasts

The All Property total return forecasts for 2008 have fallen again, driven by substantial further reductions in forecast capital value growth. The 2009 figures are similarly reduced.

Total return is expected to remain positive in 2010 but driven by an increased implied income return as capital return is now expected to fall in 2010.

The five year outlook for the sector is weak having fallen from 3.5% to 1.8% this quarter.

Figure 2: All Property total return forecasts



All Property survey results by contributor type (Forecasts in brackets are August 2008 comparisons)

Figure 3: Property advisors and research consultancies (11 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
Maximum	-0.4 (3.0)	-4.2 (-0.3)	0.8 (0.9)	-19.1 (-6.0)	5.5 (1.8)	-19.1 (-6.0)	-14.4 (-4.4)	0.5 (5.0)	12.0 (13.0)
Minimum	-2.4 (-3.4)	-10.4 (-7.4)	-11.6 (-3.2)	-25.5 (-13.7)	-11.6 (-9.9)	-25.5 (-13.7)	-20.0 (-13.0)	-7.9 (-4.3)	-4.8 (3.7)
Range	2.0 (6.4)	6.2 (7.1)	12.4 (4.1)	6.4 (7.7)	17.1 (11.7)	6.4 (7.7)	5.6 (8.6)	8.4 (9.3)	16.8 (9.3)
Median	-1.0 (-0.7)	-6.5 (-3.1)	-3.1 (0.1)	-20.6 (-10.1)	0.9 (-5.0)	-20.6 (-10.1)	-16.2 (-10.1)	-4.0 (2.7)	7.8 (8.2)
Mean	-1.0 (-0.8)	-6.6 (-2.9)	-3.9 (-0.2)	-21.4 (-10.1)	-0.4 (-4.2)	-21.4 (-10.1)	-16.6 (-10.3)	-3.8 (1.7)	6.5 (8.3)

Figure 4: Fund managers (9 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
Maximum	0.1 (1.2)	-2.1 (-1.8)	0.1 (0.1)	-19.2 (-13.3)	-6.0 (-1.2)	3.2 (6.0)	-14.4 (-8.8)	0.6 (4.9)	10.9 (12.7)
Minimum	-3.1 (-2.8)	-10.8 (-5.3)	-12.0 (-4.9)	-24.1 (-20.8)	-20.6 (-14.0)	-6.2 (-1.5)	-21.0 (-15.3)	-14.3 (-7.0)	1.8 (5.5)
Range	3.2 (4.0)	8.7 (3.5)	12.1 (5.0)	4.9 (7.5)	14.6 (12.8)	9.4 (7.5)	6.6 (6.5)	14.9 (11.9)	9.1 (7.2)
Median	-1.1 (-0.5)	-5.4 (-3.1)	-3.2 (-1.1)	-22.2 (-17.4)	-12.0 (-6.9)	-1.0 (2.8)	-16.7 (-11.4)	-4.9 (-1.0)	5.7 (8.3)
Mean	-1.2 (-0.7)	-5.9 (-3.3)	-4.6 (-1.3)	-21.8 (-16.9)	-13.3 (-6.7)	-0.5 (2.2)	-16.8 (-11.4)	-6.8 (-0.9)	6.9 (8.6)

Figure 5: Equity brokers (4 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
Maximum	-0.7 (0.3)	-3.0 (-0.5)	0.0 (0.0)	-18.0 (-12.0)	-5.0 (-4.0)	0.0 (0.5)	-12.0 (-7.0)	0.0 (1.0)	6.3 (6.1)
Minimum	-3.7 (-2.9)	-14.6 (-6.9)	-6.3 (-2.2)	-25.9 (-16.5)	-15.0 (-6.0)	-6.3 (-0.5)	-21.5 (-11.0)	-9.0 (-0.5)	-1.9 (4.2)
Range	3.0 (3.2)	11.6 (6.4)	6.3 (2.2)	7.9 (4.5)	10.0 (2.0)	6.3 (1.0)	9.5 (4.0)	9.0 (1.5)	8.2 (1.9)
Median	-2.0 (-2.4)	-8.0 (-3.5)	-4.2 (-0.3)	-23.7 (-12.7)	-12.6 (-5.0)	-1.5 (-0.2)	-18.3 (-8.2)	-7.0 (0.4)	4.8 (5.5)
Mean	-2.1 (-1.9)	-8.4 (-3.6)	-3.7 (-0.7)	-22.8 (-13.5)	-11.3 (-5.0)	-2.3 (-0.1)	-17.5 (-8.6)	-5.7 (0.3)	3.5 (5.3)

Figure 6: All forecasters (24 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
Maximum	0.1 (3.0)	-2.1 (-0.3)	0.8 (0.9)	-18.0 (-9.4)	-5.0 (-1.2)	5.5 (6.5)	-12.0 (-4.4)	0.6 (5.0)	12.0 (13.0)
Minimum	-3.7 (-3.4)	-14.6 (-7.4)	-12.0 (-4.9)	-25.9 (-20.8)	-20.6 (-14.0)	-11.6 (-3.0)	-21.5 (-15.3)	-14.3 (-7.0)	-4.8 (3.7)
Range	3.8 (6.4)	12.5 (7.1)	12.8 (5.8)	7.9 (11.4)	15.6 (12.8)	17.1 (9.5)	9.5 (10.9)	14.9 (12.0)	16.8 (9.3)
Std. Dev.	1.0 (1.4)	2.8 (1.7)	3.2 (1.3)	2.2 (2.6)	3.9 (3.0)	3.6 (2.1)	2.4 (2.4)	3.9 (3.1)	3.9 (2.2)
Median	-1.0 (-0.7)	-6.5 (-3.1)	-3.6 (-0.4)	-22.1 (-16.0)	-11.5 (-5.0)	-1.1 (1.8)	-16.9 (-10.6)	-4.8 (0.5)	5.9 (8.0)
Mean	-1.2 (-0.9)	-6.6 (-3.2)	-4.1 (-0.8)	-21.8 (-15.7)	-11.5 (-5.5)	-0.8 (1.8)	-16.8 (-10.6)	-5.3 (0.3)	6.2 (8.0)

Notes

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

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

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

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

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

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

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

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

Survey summary results by sector

Figure 7: Sector summary

	Rental value growth %				Capital value growth %				Total return %			
	2008	2009	2010	2008-12	2008	2009	2010	2008-12	2008	2009	2010	2008-12
Office	-2.8	-10.3	-6.2	-3.4	-22.6	-13.3	-2.3	-5.8	-17.8	-7.3	4.5	0.5
Industrial	-0.5	-4.7	-3.0	-1.4	-20.9	-10.2	-0.6	-4.6	-15.4	-3.3	7.0	2.6
Standard shops	0.2	-4.2	-3.1	-0.8	-19.4	-9.4	0.4	-3.2	-14.3	-3.4	6.9	2.9
Shopping centres	0.0	-3.6	-1.9	-0.2	-21.4	-9.5	0.5	-3.8	-16.6	-3.4	7.1	2.3
Retail warehouses	-0.6	-4.7	-2.7	-0.6	-23.0	-10.5	-0.3	-4.5	-18.4	-4.7	6.3	1.6
All Property	**-1.2**	**-6.6**	**-4.1**	**-1.9**	**-21.8**	**-11.5**	**-0.8**	**-4.7**	**-16.8**	**-5.3**	**6.2**	**1.7**
West End offices	-3.2	-12.0	-6.2	-3.4	-22.9	-15.4	-1.4	-5.7	-19.0	-10.5	4.3	-0.6
City offices	-6.9	-15.1	-8.3	-5.3	-25.2	-15.4	-2.8	-6.9	-20.7	-9.7	3.8	-0.8
Office (all)	-2.8	-10.3	-6.2	-3.4	-22.6	-13.3	-2.3	-5.8	-17.8	-7.3	4.5	0.5

The 24 contributors to this quarter's forecasts at the All Property level include 11 property advisors, 9 fund managers and four equity brokers. Of these, 23 contributors provided sector forecasts and 19 provided West End and City office segment forecasts (10 property advisors, 6 fund managers and 3 equity brokers). All forecasts were produced in either October (10) or November (14) for this edition. This edition of the IPF UK Consensus Forecast also contains a property derivatives price curve for information purposes.

Notes

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

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

The sector figures are not analysed by contributor type, with all figures shown at the all-forecaster level.

In the charts and tables 'All Property' figures are for the full 24 contributors while the sector forecasts are for the reduced sample (23) of contributors.

Acknowledgements

The Investment Property Forum wishes to thank the following organisations for contributing to the IPF UK Consensus Forecasts in November 2008:

Property advisors (includes research consultancies): AtisReal, Capital Economics, CBRE, Colliers CRE, Cushman & Wakefield, Experian BSL, Fletcher King, GVA Grimley, Jones Lang LaSalle, Paul Mitchell Real Estate Consultancy, Real Estate Forecasting Limited and one that wishes to remain anonymous.

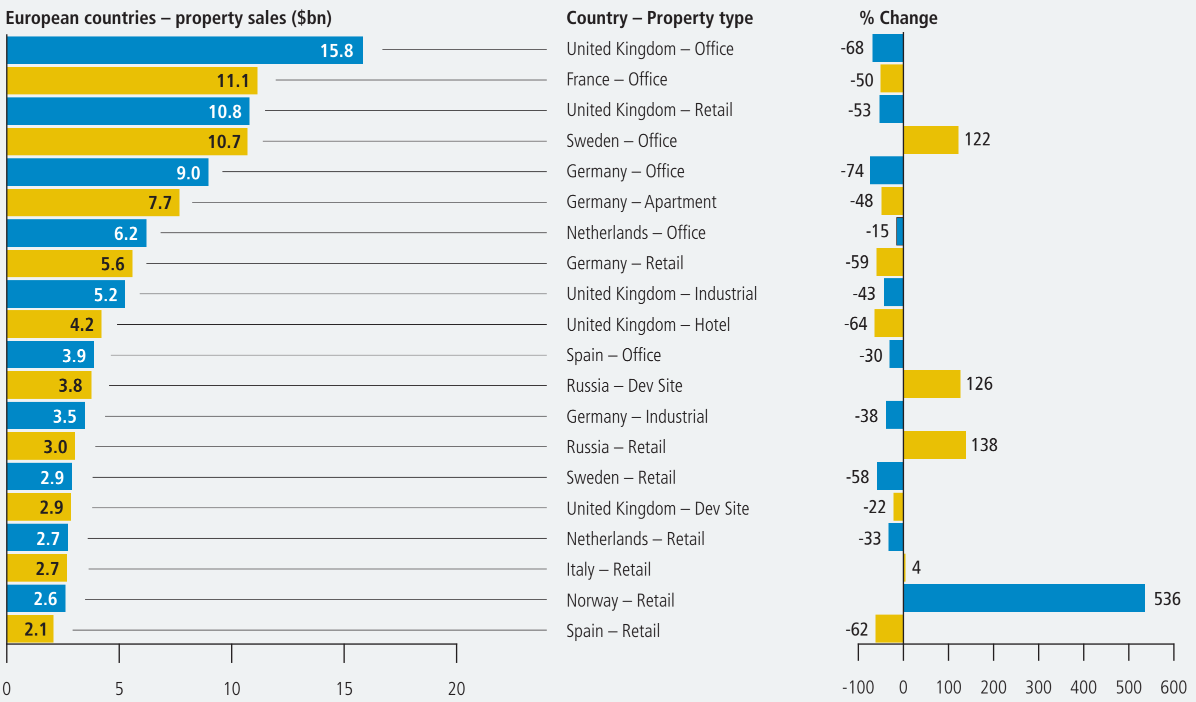
Fund managers: Aberdeen Property Investors, Aviva Investors, CBRE Investors, Cordea Savills, F & C Property Asset Management, HSBC Real Estate Multimanager, ING REIM (UK) Ltd, Invista REIM, La Salle Investment Management, PRUPIM, RREEF Ltd, Standard Life, SWIP.

Equity brokers: Exane BNP Paribas, Nomura International Plc, Morgan Stanley and one that wishes to remain anonymous.

European sales volumes

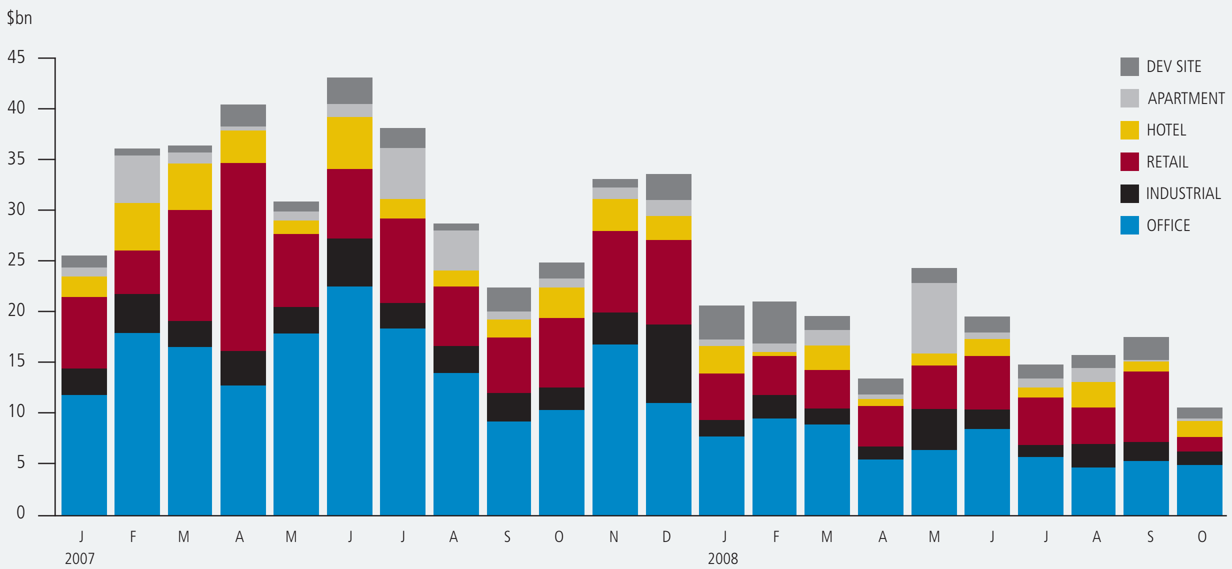
The data below is provided by Real Capital Analytics. For further information, see www.rcanalytics.com.

Figure 1: European transactions by country and sector



Source: Real Capital Analytics, Inc. 2008

Figure 2: European transaction volumes by property sector



Source: Real Capital Analytics, Inc. 2008. For more current deals, cap rates and property details visit www.rcanalytics.com

European Consensus forecasts November 2008

This is the fifth Investment Property Forum consensus survey of European office market rental forecasts. The survey brings together the forecasts undertaken by European property analysts in much the same way as the IPF UK Consensus Forecast project.

At present the IPF European Consensus Forecasts survey focuses on office rental value growth in major cities. It is not possible at this stage to assemble sufficient forecasts of all sectors across all European countries to produce a meaningful consensus of views. For the third time, in addition to the rental value forecasts, we have run a consensus survey of forecast IPD European total returns by sector. The samples provided for this survey were once again small, and not sufficient to permit publication. We do hope to be able to produce a full release of this data at some time in the future, once the number of responses has grown sufficiently.

The Data

The number of major European centres for which contributors are asked to provide prime office rental forecasts has been increased from 24 to 30. The new centres included in this survey are Lyon, Hamburg, Luxembourg, Moscow, Oslo and Zurich. The growth forecasts provided by each organisation have been analysed to provide average ('consensus') figures for each market.

This latest survey collected prime office rental forecasts for the 30 centres for the calendar years 2008, 2009 and 2010. We requested a three-year average forecast for 2008-2010 if individual years were not available, and a five-year average for 2008-2012. The survey requested both the percentage annual rental growth rates and also year-end rent levels.

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

Data from nine organisations was included in the pilot study survey in Spring 2006. The number of contributors rose to 11 for the first full survey which was completed in November 2006, and reached 13 for both the 2007 surveys. 15 organisations contributed to the Spring 2008 survey, and the same number have contributed to this latest survey.

Key Points

Onset of recession to bring falling rents across Europe in 2009 and 2010

Virtually all European centres are now expected to see falling rental values in 2009 and 2010, the result of the increased likelihood of recession taking hold in most countries during these years. This is a major adjustment compared to the forecasts covered in our previous survey in the Spring. Most of the forecasts included in the survey were made in August and September, so October's global financial crisis will be pushing rental expectations even lower than the figures reported here.

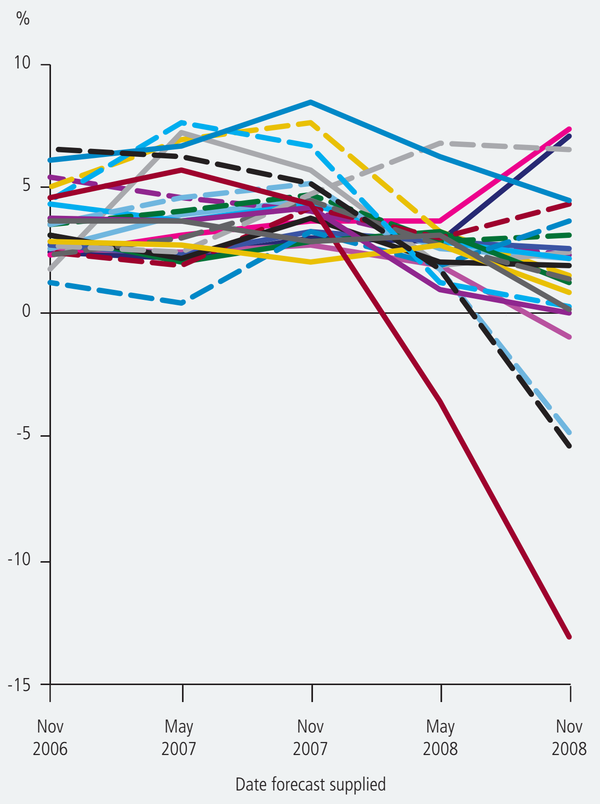
Figure 1: European Office Market Prime Rent Forecasts, as at October 2008

	Year rental growth forecast % pa			3-year forecast 2008-10 % pa	5-year forecast 2008-12 % pa
	2008	2009	2010		
Vienna	7.0	0.7	-1.6	2.0	-0.1
Brussels	-1.0	-1.4	-1.2	-1.2	0.9
Prague	7.2	1.6	-0.6	2.7	2.8
Copenhagen	2.0	-1.4	-1.5	-0.3	0.9
Helsinki	2.2	-0.5	-0.3	0.5	1.8
Lyon	3.9	-0.1	-1.2	0.8	1.7
Paris CBD	1.4	-2.6	-0.9	-0.7	1.8
Paris la Defense	2.3	-3.3	-1.3	-0.8	1.5
Berlin	2.5	-0.1	-0.7	0.5	1.2
Frankfurt	2.1	-2.0	-0.4	-0.1	1.6
Hamburg	4.7	0.3	-0.1	1.6	2.3
Munich	3.0	1.3	-0.6	1.2	2.1
Athens	1.1	-0.8	0.7	0.3	--
Budapest	3.6	-1.3	-2.4	0.0	1.9
Dublin	-4.9	-8.3	-3.4	-5.6	-1.9
Milan	4.3	-3.1	-3.2	-0.7	1.6
Rome	1.8	-2.4	-2.2	-1.0	1.6
Luxembourg	6.3	-0.9	0.6	1.9	2.1
Amsterdam	1.3	-2.2	-0.8	-0.6	1.9
Oslo	-0.8	-6.0	-0.1	-2.3	0.0
Warsaw	6.4	1.7	-1.1	2.3	2.5
Lisbon	0.8	-1.0	-1.7	-0.7	1.2
Moscow	23.4	1.4	-0.4	7.7	7.2
Madrid	0.2	-10.1	-7.6	-5.9	-2.2
Barcelona	-0.1	-7.5	-4.3	-4.0	-0.4
Stockholm	4.4	-0.9	-0.8	0.9	2.1
Zurich	0.8	-2.1	0.9	-0.2	0.5
London: City	-13.1	-12.7	-5.0	-10.3	-3.2
London: West End	-5.4	-9.2	-5.8	-6.8	-0.7
Manchester	0.0	-3.2	-3.7	-2.3	0.6

The City of London is forecast to show by far the largest rental falls over 2008-2010, with declines of around 13% expected for both 2008 and 2009, and significant further deterioration in 2010. Most other European markets are expected to see their biggest falls in 2009, with London's West End, Dublin, Madrid and Barcelona particularly hard hit.

All but five of the 24 centres covered have had their forecasts for 2008 revised downward once again, with Dublin showing the most significant adjustment outside the UK, from 1.6% to -4.9%. Rents in Prague and Vienna have held up much better than expected as the year end approaches, with both forecast to see growth in excess of 7%. But the highest out-turn is predicted for Moscow, one of the new centres covered in the survey, with growth currently forecast to be in excess of 20%.

Figure 2: Forecasts for year 2008



Key for Figures 2-4

Vienna	Helsinki	Frankfurt
Brussels	Paris CBD	Munich
Prague	Paris la Defense	Athens
Copenhagen	Berlin	Budapest
Dublin	Warsaw	Stockholm
Milan	Lisbon	London City
Rome	Madrid	London West End
Amsterdam	Barcelona	Manchester

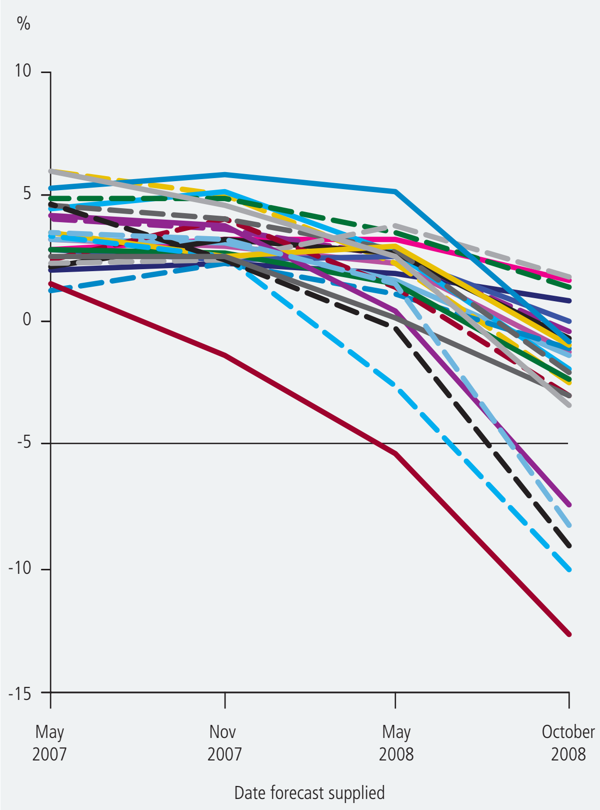
All forecasts downgraded for 2009

Every one of the centres covered has seen its 2009 forecast downgraded since the Spring survey. Just four locations are now expected to witness positive growth next year – Warsaw, Prague, Munich and Vienna.

Stockholm's position in the forecast ranking has deteriorated significantly. Having been one of the top four locations in each of the previous four surveys its 2009 forecast has been downgraded in this survey from 5.1% to -0.9%. Oslo, which enters the survey for the first time this Autumn, showed one of the weakest predictions for 2009 with an anticipated decline of 6%.

Otherwise, apart from the London, Spanish and Dublin markets, all forecast growth rates fall within the relatively narrow range -3.3% to +0.7%.

Figure 3: Forecasts for year 2009

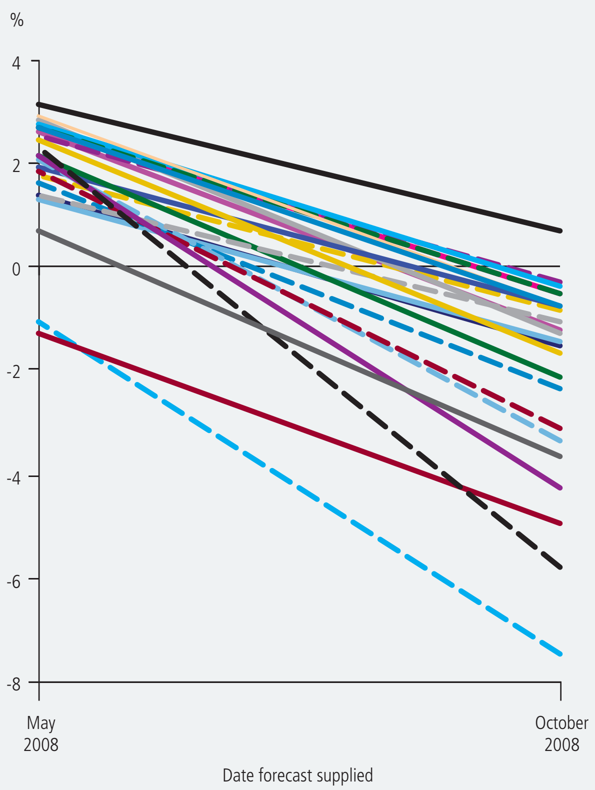


Only Athens, Luxembourg and Zurich positive for 2010

The first forecasts received for 2010 show European office markets' rental values as expected to continuing falling. The two London forecasts plus Madrid and Barcelona stand out from the rest of the figures with significant reductions in rental values forecast for these cities. However, only three of the smaller markets covered, Athens, Luxembourg and Zurich, are showing marginally positive forecasts for the year. All the other markets are forecast falling rental values through 2010, though most within a narrow band of between -3.5% and zero.

Throughout the European markets covered, there are no clear signs of a recovery in prime property rents in evidence for 2010.

Figure 4: Forecasts for year 2010



Notes

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

The IPF welcomes new contributors for future surveys, so that the coverage of the market participants can be widened. If your organisation wishes to contribute to future surveys please contact Tim Horsey, consultant to IPF, at THorsey@ipf.org.uk.

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

Contributors to the IPF European Consensus Forecasts, October 2008

Aberdeen Property Investors
AEW Europe
Aviva Fund Management
Blackrock
DTZ
CBRE
Cushman & Wakefield
Experian
Henderson Asset Management
ING Real Estate
Invesco
Jones Lang LaSalle
King Sturge
PMRECON
Standard Life Investments

Sustainability – is it more relevant or less relevant in the downturn?

Does the worsening economic outlook push sustainability down the corporate agenda? If you consider sustainability to be an optional extra or a luxury item it might. But given that the drivers for more sustainable buildings, i.e. ones that are resource efficient, accessible, flexible and well designed, are largely regulatory and finance or cost driven, then the answer would have to be no. Sustainability is here to stay. The worsening economic outlook makes it even more important that all property acquisition, refurbishment and letting decisions take account of sustainability in an informed, coherent and cost effective way.

Three sustainability focused research projects are due to be published through the IPF Research Programme during Winter 2008. They focus on three issues with which the market is currently grappling:

- The cost of carrying out energy efficient upgrades to the existing commercial stock;
- Occupier demand for sustainable offices; and
- How the landlord and tenant relationship can support sustainability, or 'green leases'.

These are three areas the market needs to have a better grasp of if more sustainable buildings are to become a standard feature within the commercial property markets. Not achieving this runs the substantial risk of having legislation, regulation and fiscal penalties imposed on the market by a Government targeting commercial property as a quick win in the drive towards a low-carbon economy.

Figure 1: Energy efficiency gains

		Cumulative % saving			
	Market improvement (£1000/m²)	+£25/m² budget	+£50/m² budget	+£75/m² budget	+£150/m² budget
Office 1	25	37	47	49	54
Office 2	26	39	46	52	58
Office 3	25	35	46	48	54
Office 4	25	35	42	46	54
Office 5	0	14	28	29	36
Office 6	30	47	51	55	63
Office 7	24	39	50	51	54

The projects generate useful conclusions in their own right, but taking an overview of all three provides an interesting insight into how the market is currently responding to this issue. The work on the cost of energy efficient refurbishments by Cyril Sweett shows that it is possible to generate substantial improvements in energy performance simply by upgrading the stock to current market standards, i.e. by doing no more than what the market currently expects. This applies particularly to 1990s air conditioned office buildings where equipment is due for upgrade, and to pre-war stock. Spending an extra 5% on a refurbishment budget pushes the energy efficiency gains to be made even further (see Figure 1 below).

Louise Ellison, Research Director, Investment Property Forum

This work makes it clear that the technology is available to upgrade the existing commercial stock cost effectively and in ways that generate positive internal rates of return on invested capital. The other two projects, however, show substantial weaknesses both in terms of what the occupiers are requiring in relation to sustainability when they acquire new space, and in how landlords and tenants deal with sustainability issues between them.

Focusing on occupier demand, Oxford Brookes[1] interviewed 50 commercial property occupiers about property acquisitions that had taken place within the previous 24 months. This was followed up with 5 in-depth case studies examining specific deals in more detail. The work is very different from other surveys of occupier demand for sustainable buildings in that it looks at what **has** happened in specific moves rather than what occupiers say **would** happen if they were to move.

The building an occupier occupies ultimately is a product of many variables. The main drivers will be location, availability and cost, all of which will be set out in the agent's brief at the beginning of the search process. If a characteristic is not included in the agent's brief it is very unlikely to feature in the buildings offered, unless it is an unavoidable feature of the market. The research revealed that a little under a third of respondents reported specifying a minimum level of environmental performance when briefing agents and just 3 of the 50 respondents specified 'sustainability' explicitly as a requirement when seeking new space. Some indicated that if they were looking again now it would more likely be included, but this is still a sobering statistic. The finger could be pointed at the agents (and often is) for not identifying sustainable buildings for their clients, but if clients don't ask for them why would the agent look for them?

So the research suggests sustainability has not been high on the list of occupier requirements over the last 24 months particularly when compared to issues such as location, available stock, and overall running costs. Those who moved more recently placed sustainability higher on their priority list, from which one could interpret that interest is shifting. This may relate to greater market awareness as a result of the introduction of EPCs or, perhaps higher energy prices. Interestingly whilst the Oxford Brookes' research estimates that less than 7% of new build UK commercial property stock is BREEAM rated, 40% of the respondents ultimately occupied buildings with a BREEAM rating of good or above. This could suggest that there are sustainable buildings out there in the market place whether occupiers are looking for them or not. This point is further supported in the case studies.

1 This work for carried out for IPF by Oxford Institute for Sustainable Development (OISD) at Oxford Brookes University

For the third project, Kingston University interviewed landlords and tenants to investigate how the landlord and tenant relationship is impacting on sustainability, if at all, and current perceptions of green leases. This work goes to the heart of delivering sustainability at the operational level within the building stock. Without a means of developing more of a partnership arrangement between landlord and tenant it will be very difficult for even the most sustainable building to make any significant impact in reducing carbon emissions.

The research revealed a strong desire amongst both parties to work more closely together in this area but, also, great scepticism as to what can actually be achieved. It is fair to say that the green lease as a concept was uniformly unpopular with the interviewees, both landlords and tenants, although for different reasons. Tenants saw it as a potential means of making them pay for environmental upgrades from which they would see little or no business benefit, and as potentially restricting their ability to use their space as they felt best suited their business. Landlords saw green leases as having a potentially negative impact on investment performance by making a property more difficult to re-let and a full market rent harder to achieve.

Both parties saw the need for more collaborative working to improve the environmental performance of buildings in operation. They were warm to the idea of a memorandum of understanding being negotiated between landlord and tenant with mutually achievable and beneficial terms. The great difficulty, as always, arises as soon as money is mentioned. The perception remains that implementing anything sustainable is going to be expensive. The landlords generally perceive it as an extra expense which will hit the performance of their investment but benefit the tenant. The tenant on the other hand is suspicious of being 'made' to pay through service charges, increased rents and increased rates for improvements to the landlord's asset.

This brings us back to the Cyril Sweett work. It is clear that cost need not be a major issue in upgrading buildings to more energy efficient standards. Some of the upgrades recommended generate a payback in less than a year, but this is a payback that accrues to the tenant in the form of lower energy bills. With this information available one hopes that a negotiation between landlord and tenant as to how this could be apportioned might be more fruitful. But it seems necessary for the initiative to come from the landlord side. There are clearly some occupiers out there who have strong corporate social responsibility policies, but Oxford Brookes' work suggests there are few occupiers actively seeking sustainable property to occupy. One might further surmise from this that few are considering how their corporate property affects their corporate policy either.

Landlords have an increasingly strong driver to upgrade their stock to energy efficient standards. Occupiers may not be looking for sustainable buildings yet but regulatory change will inevitably make poorly-performing buildings less attractive to tenants, either through higher running costs and/or fiscal penalties. Opportunities to upgrade buildings come relatively infrequently in the building life-cycle and should be used as effectively as possible. As is clear from the Cyril Sweett work, energy efficient upgrades can be done at no additional cost over and above that required for a market standard refurbishment, although achieving effective future-proofing through an uplift to the budget might be a sensible option to investigate.

The big hurdle to tackle for sustainability is occupier behaviour in terms of building operation. The Kingston University research suggests green leases are unlikely to be an effective solution. A partnership-oriented relationship between landlord and tenant is clearly the way to go but the lack of trust between the two parties currently makes anything legally binding or incorporating financial incentives and penalties unattractive to both parties. Agents will have an important role to play here in informing clients about the sustainability credentials of buildings. They could have an even stronger impact by supporting them through the negotiation of memoranda of understanding in relation to the operation of the building. This will undoubtedly require the property agents to raise their own game in terms of sustainability, and many might say, about time too.

Note: The Oxford Brookes research referred to in this article is still in progress and therefore findings are subject to change.

Hot in the city
More on-site or near-site generation?

There can be no clearer statement of the interlinking of the climate change and energy agendas than the creation in October 2008 of the Department of Energy and Climate Change (DECC). Tasked with dealing with both the impending energy generation gap and delivering on the UK's international target for Greenhouse Gases (GHG) reduction, it has already taken the bold step of increasing the GHG reduction target for the year 2050 from 60% of 1990 levels to an 80% reduction; both extremely ambitious.

It is clear that property owners and developers will be forced to play a large part in the delivery of any GHG reductions implemented by the provisions in the Climate Change Bill (CCB), the Carbon Reduction Commitment (CRC), as well as through the planning system, including, amongst others, the climate change supplement to Planning Policy Statement 1 (PPS1) and the Planning and Energy Bill. This is in addition to existing requirements in Building Regulations, the Code for Sustainable Homes and the new requirements for energy performance certificates (EPCs) and display energy certificates.

Climate Change Bill (CCB)

The CCB was introduced in 2007 and is expected to receive Royal Assent by the end of 2008 or early 2009. It will set a statutory target for the UK to achieve an 80% reduction in GHG emissions based on 1990 levels of output by the year 2050. It will also have an interim reduction target of between 26% and 32% by 2020. Achievement will be overseen by a new Committee on Climate Change, which will set five year carbon budgets for the country.

The proposed CRC is a mandatory emissions trading scheme aimed at cutting emissions from large commercial and public sector organisations. The 'obligated entities' will include all:

- central and local government departments irrespective of energy used; and
- businesses and organisations with half hourly energy metering with a consumption of at least 6,000 MWH per annum. Typically this translates to an electricity bill of approximately £500,000 per annum across the organisation.

Organisations must look to their electricity usage to check whether they are likely to be included. If so, they must then convert their electricity and other energy usage (excluding transport) into CO_2 emissions, using standard formulae. The CO_2 allocation will be for the entire organisation and must not be exceeded. The aim is to force obligated authorities and business to always look towards CO_2 reduction within their existing portfolio or estate and on each refurbishment or new development.

The first set of allocations will be auctioned off at a set price. As with the existing EU Emissions Trading Scheme, there will be a fixed amount of allocations. The first phase of the scheme is likely to run for three years and if it follows other trading schemes, more organisations are likely to be caught in the future while the number of CO_2 allocations available will be restricted.

Paul Rice, Partner, Planning & Environment, Pinsent Masons

ESCOs and MUSCOs

Not least because on-site generation is likely to be required in future through the planning system, the introduction of the CRC will drive government bodies, developers, purchasers and tenants to look for lower carbon buildings. Developments with decentralised and integral low carbon generation are becoming more common. Often the developer will employ or establish an energy services company (ESCO) to design, build, operate and maintain the on-site or near-site infrastructure. There are numerous examples of ESCOs being in partnership with the developer, occupiers, the local authority or otherwise wholly owned by a specialist energy management company. Where the infrastructure also incorporates other services such as telecoms then the vehicle is often referred to as a multi-utility services company (MUSCO).

There are however, a host of limiting factors to easy and full implementation of on-site generation and distribution schemes, not least restrictions on the ability to require tenants or residents on site to enter into long term contracts for the purchase of the energy generated. This stems from the Electricity Act 1989 as well as requirements to allow other energy companies to have access to energy infrastructure. Moreover, a recent European Court of Justice ruling has found that an on-site energy generation and supply system at the Leipzig airport which supplied the airport and 93 other undertakings on the site with electricity was unlawful under EU competition law. This case arose out of a challenge against the scheme by a local utility.

While these legal obstacles (and there are a host more) present big problems for the full roll out of ESCOs across the UK, they are not insurmountable. Nevertheless, discussions with planners will be needed at the outset to agree what is realistic and deliverable on any planned development.

Forum activities and announcements

Annual Dinner 2008

IPF Events

IPF Dinner

Balloons filled the Great Room at the Grosvenor House for our 20th Anniversary Dinner on 26 June. We were delighted to be joined by many of the IPF's past Chairmen who together have steered the IPF to become one of the industry's most respected bodies. Following the Dinner, Ian Hislop, in his own inimitable style, entertained the audience.

Annual Dinner 2008

The event was kindly sponsored by CoStar, Knight Frank and Nationwide Commercial.

Midlands Dinner

The Midlands Annual Dinner took place on 16 October at the ICC. Despite the economic downturn, over 550 people filled Hall 4 of the ICC in what is regarded by the property industry as one of the best social events in the calendar.

Andrew Hynard, National Chairman of the IPF, gave a speech outlining some of the extraordinary swings in the performance of property as an asset class over the last 12 months including and then went on to present cut glass as thank you gifts for the services provided by the past Chairman of the Midlands Board, since it was formed over eight years ago, namely: Andrew Brazier, Tim Hurdiss, Hapri Yorke-Brookes, Andrew Yates and David Allen.

Andrew Hynard, IPF National Chairman and Adrian Watson, IPF Midlands Region Chairman, pictured at the Midlands Dinner

The event was kindly sponsored by Abstract Land, First Title, GBR Property Consultants, and Lloyds TSB Corporate Markets.

Sue Forster with members of the IPF Northern Board

Northern Dinner

Held once again at The Lowry in Manchester, 180 property professionals greatly enjoyed this event. Local Chairman Andrew Quinlan opened proceedings and then introduced National Chairman Andrew Hynard. Following the delicious meal, local comedian John Bishop was the after-dinner speaker.

The event was kindly sponsored by Addleshaw Goddard, Knight Frank and Lloyds TSB Corporate Markets.

Comedian John Bishop, entertaining us at the Northern Dinner

Other events

In addition to the large dinners, both Scotland and the Midlands Region held informal drinks parties.

Future events

Annual Lunch – 28 January 2009

Midlands Lunch – 24 April 2009

Annual Dinner – 24 June 2009

Midlands Dinner – 8 October 2009

CPD

In the current economic climate, education, networking and discussion are more vital than ever. The IPF has therefore made all lectures free to members in our 20th anniversary year.

Our **Autumn 2008** CPD season was a great success. In total, over 350 people attended CPD events in London and the regional events were equally well supported.

Highlights included the lectures: Investing for recovery; Defensive strategies; and Debt: Threat or opportunity.

Any member unable to attend the meetings will be able to download the presentations (speaker permitting) from the members area of the IPF website.

The **IPF Winter/Spring 2009** season of CPD includes two of our flagship lectures – Outlook for UK Property and Outlook for Global Property.

The CPD calendar for Winter/Spring 2009 will be released in mid-December and we are hoping that our new online booking system will be up and running by then.

Investment Education Programme

The Investment Education Programme is a series of flexible modules which can be taken individually, or as a complete course. By successfully completing the full assessed course, candidates are awarded the IPF Diploma and can use the designation Dip IPF, if they so choose.

The Investment Education Programme e-learning module, Property as an Asset Class provides an excellent, flexible introduction to property investment. Members rate for this module is £150.

The modules Investment Valuation & Portfolio Theory and Financial Instruments & Investment Markets took place in September and November respectively and were very well subscribed.

Remaining IEP modules this cycle are:	
• **Property Investment Appraisal**	27, 28, 29 January 2009
• **Property Finance and Funding**	3, 4, 5 March 2009
• **Indirect Property Investment**	21, 22, 23 April 2009
• **International Property Investment**	2, 3, 4 June 2009
• **Portfolio Management**	1, 2, 3 September 2009

Further details and fees for all modules can be found on the IPF website **www.ipf.org.uk** or by contacting Frankie Clay, IPF Education and Research Manager on fclay@ipf.org.uk.

Getting into Property Derivatives

The IPF's Property Derivatives Interest Group (IPF PDIG) has recently launched Property Derivatives Tool-Kit which is designed to help potential property derivative end-users become better informed about the property derivatives market.

The publication **'Getting into Property Derivatives'** addresses some of the hurdles to participation in the property derivatives market encountered by many property investors. It provides:

- An introduction to the market, examining key **concepts** that need to be understood by potential users, such as pricing, the advantages and disadvantages of the instruments and the potential strategies that investors can employ by using property derivatives;
- An operational '**toolkit**', designed to identify the pre-requisite regulatory and operational procedures that property investors need to have in place before they are able to trade; and
- Four separate **case studies** that illustrate why and how other investment managers have begun to use property derivatives.

The publication has been sent to all IPF members and is also available to download from the IPF and PDIG websites: **www.ipf.org.uk** and **www.propertyderivatives.co.uk**.

Investment Property Forum

Annual Lunch 2009

YEARS OF THE IPF
1988-2008

Wednesday 28 January 2009 12:00 for 12:30 | Lounge Suit

Grosvenor House Hotel, Park Lane, London W1

Ticket Price £102.00 + VAT (total £119.85 per person, excluding wine and liqueurs)

Guest Speaker Sir Ranulph Fiennes, the World's Greatest Living Explorer

Ranulph Fiennes was born in 1944 and educated at Eton. He served with the Royal Scots Greys for a time before joining the SAS. He was awarded the Sultan of Oman's Bravery Medal in 1970, the Explorers Club of New York Medal in 1983, the Royal Scottish Geographical Society's Livingstone Gold Medal in 1983, the Royal Geographical Society's Founder's Medal in 1984, and both he and his late wife received the Polar Medal in 1987.

In 1993 he was awarded an OBE for 'human endeavour and charitable services'.

Sir Ranulph has led 22 major expeditions to remote parts of the world including both Poles. In 2003, only 3½ months after suffering a massive heart attack and double bypass operation, he ran 7 marathons on 7 continents in 7 days. In 2004 he came second in the International North Pole Marathon and, in 2005, he raised £1.8m through his ascent to within 300 metres of the Everest summit ridge.

He is the author of 16 books including The Feather Men (a UK No 1 Best Seller), Beyond the Limits, and his latest, Captain Scott, the best-selling biography of 2003. **Sir Ranulph is a remarkable man and truly inspiring speaker.**

Please reserve tables for the Annual Lunch by completing a booking form and returning it with payment, as soon as possible. Tables will be for ten or twelve (limited availability of larger tables). Individual bookings can be made and, in this case, please indicate if you wish to join a table with specific people. All business associates and colleagues are welcome.

For more information or to book, contact Ingrid Styles on 020 7194 7920 or email Ingrid on istyles@ipf.org.uk

This event is kindly sponsored by:

CHASE & PARTNERS C&P

VALAD VALAD PROPERTY GROUP

IPF Investment Property Forum

Investment Property Forum
New Broad Street House
35 New Broad Street
London EC2M 1NH

Tel: 020 7194 7920
Fax: 020 7194 7921
Email: ipfoffice@ipf.org.uk
www.ipf.org.uk