IPF Investment Property Forum

INVESTMENT PROPERTY FOCUS

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Property Investment: A new landscape

Report from the IPF Conference in Scotland

In this issue:

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From the editor

Sue Forster, Executive Director, IPF

In this edition of Investment Property Focus, the IPF's new Chairman, **John Gellatly** of Aviva Investors talks about his forthcoming year in office and outlines his three main priorities for his term, being: ensuring the re-financing of our Research Programme; extending the Forum's membership; and building relationships with various government departments and other authorities.

One example of where the IPF is already engaging actively with external organisations and authorities is through the Property Industry Alliance Debt Group, chaired jointly by John and Phil Clark of AEGON Asset Management. The De Montfort University research into the UK commercial property lending market is a key data source for the Group and the findings of the latest survey are outlined on pages 3-9 by **Bill Maxted** and **Trudi Porter** from the University. Their results show that while the debt secured by commercial property increased only marginally during the year, the combined value of loans in default and breach of financial covenant now represents almost 25% by value of the total £228.3bn reported to the research.

Max Sinclair of Eurohypo, speaking at the IPF Property Investment Conference in Scotland, emphasised that the events of the last two years mean that the banks will be major players in the property market for some time to come. They are reaching the stage where they will want to focus on relationships so he advised the delegates to, "start building relationships with the banks now and there will be opportunities to work with them and make money".

Other speakers at the conference were **John Gellatly**, **Lucy O'Carroll** of Lloyds Banking Group, **Andrew Smith** of Aberdeen Asset Management and **Ian Watson** of Hansteen Holdings. There was much talk about the need for de-leveraging within all sectors of the UK economy and Ian thought we could be in for, "a long period of grisly, grinding difficult times". On a more upbeat note, the speakers saw this market is an opportunity for professionals who understand property.

The June IPF Survey of IFAs found that market uncertainties have led to a heightened aversion to risk, with IFAs recommending reduced allocations to property and higher hurdle rates for expected returns than those posted in early 2010.

The picture from the institutional investors' perspective is slightly different. Recent research by **Paul Mitchell** of Paul Mitchell Real Estate Consultancy found that institutional exposures to property are set to increase, both in the UK and internationally, and there is likely to be a move towards direct investment and joint ventures because of the issues that arose from investing via non-listed property funds during the downturn. These issues are considered in more detail by **Deborah Lloyd** of Nabarro. She emphasises the need for a robust alignment of fund managers' and investors' interests; comprehensive corporate governance; and greater accountability and transparency by fund managers.

Given the demand for property investments, where is the stock going to come from? **Stuart Morley**, **Dan Francis, Richard Levis** and **Andrew Screen** of GVA Grimley consider the possible options. They expect a steady flow, rather than a flood, of properties coming to the market from the banks and increase is asset disposals by the public sector as a result of spending cuts but, in both cases, the quality of the assets will be very mixed. The low level of building starts mean that new developments are not likely to prove a major source. However, they are optimistic that private sector sale and leasebacks will provide a valuable source for investors over the next few years.

The figures from the May 2010 IPF UK and European Consensus Forecasts are also included in this publication.

The next edition of Focus will be published in late November/early December. If there are any topics you think we should include, please contact me.

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Message from the Chairman

John Gellatly, Aviva Investors

I feel extremely privileged to be appointed Chairman of the Forum – this is an outstanding organisation, with an outstanding group of members.

A review of the Forum's achievements during the past year underlines its vibrancy, the dedication of those that contribute to our events and initiatives, and the high standing that other hold us in, and their desire to engage with us. Some of the highlights include:

- Over 50 different events organised, with over 100 individuals who gave of their time to speak or chair at these events;
- The Research Programme generated six major projects, seven short papers and also continued to produce four regular quarterly publications; and
- 33 people were awarded the IPF Diploma from the Investment Education Programme, meaning that more than 500 people have now completed at least one of the modules in the Programme.

Perhaps the greatest achievement of the Forum this year is that it weathered the fallout from the credit crunch. In doing so, we faced some difficult challenges and I would particularly like to express my thanks to our immediate past Chairman, Peter Pereira Gray, for his thoughtful and decisive stewardship of the Forum through that period. Peter also challenged us last year to consider how best the Forum might evolve and face the new strategic issues post crunch.

So if last year was about considering how the Forum might best serve its members in a more constrained environment, I believe my year in office needs to be marked by successfully executing those strategies that were identified:

- We need to ensure the re-financing of our Research Programme from April 2011. Now more than ever, there is a clear need for high-quality, objective analysis from a world-renowned industry research effort. That is what the IPF Research Programme provides;
- We need to focus on our membership and seek to achieve three interlinked goals:
  - Increase membership numbers but without diluting the quality and characteristics of our organisation. This will provide a firmer financial footing for the Forum going forward;
  - Recruit more younger members. These are the lifeblood of any organisation and are the future leaders of our industry. We want and need them as members; and
  - Extend our membership into the banking and wider capital markets. Whether we like it or not, the reality of the next few years is that the workout of the debt overhang, often using capital markets solutions, will dominate our environment. We therefore need more members from these areas to ensure that we understand the forces shaping our industry and conversely that other areas of the financial markets have an understanding and appreciation of property as an asset class and the role we play in the economy.
- The final area on which we need to focus is that of building relationships with the various government departments and other authorities. The IPF stands for independence, integrity, education and research. These attributes have become increasingly recognised and welcomed, especially at a time when we have a new government, new ministers and a regulatory environment that we know is about to undergo fundamental change.

The IPF has played an integral part in the Property Industry Alliance (PIA) Debt Group to prepare reports and briefings for HM Treasury, the Bank of England and the FSA. I hope that we can increase our contribution over the course of this year.

To achieve these goals we need a strong Management Board, supported by the members of the all the Forum's committees and special interest groups. I am therefore delighted that Stephen Brown of GVA Grimley, Toby Courtauld of Great Portland Estates, Ian Cullen of IPD, Andrew Hynard of Jones Lang LaSalle, Guy Morrell of HSBC, Peter Pereira Gray of The Wellcome Trust, Rosalind Rowe of PricewaterhouseCoopers and Michael Stancombe of Hogan Lovells have agreed to remain on the Board and that Chris Ireland of King Sturge, Max Sinclair of Eurohypo and the Chair of our Research Steering Group, Andrew Smith of Aberdeen Asset Management, have become Board members.

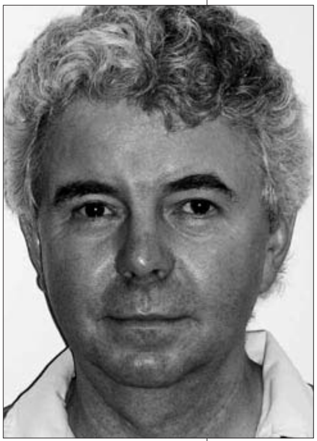
Sadly, three members of the Board have stepped down – Fiona Morton of Ryden, Mark Titcomb of DekaBank and Ian Womack of Aviva Investors. I should like to thank them for their huge contribution to the Forum and the industry as a whole.

I should also like to thank the many people who serve on our main committees, the Midlands, Northern and Scottish regional boards and our five special interest groups to deliver such an impressive programme of events and research. I hope we can encourage more members to get involved; whether by joining a committee or perhaps providing a venue for seminars so that we can continue to run these free of charge to members.

So this is a year of execution with some clear deliverables. I hope, with the membership's support, to hand over the Forum to my successor in at least as good shape as I received it.

STOP PRESS: I am delighted to announce that as part of our move towards greater engagement with those in the capital markets, the Forum has just agreed with the Association of Property Bankers (APB) to establish a joint Property Banking Group. This Group is intended to further the objectives of both organisations, providing a platform for discussion and debate between lenders and others involved in property finance and investment.

The UK commercial property lending market



Bill Maxted, Department of Corporate Development, De Montfort University

Trudi Porter, Department of Corporate Development, De Montfort University

De Montfort University published its twelfth year-end research report on lending patterns of the major commercial property lenders operating within the UK In May 2010. The analysis, covering the year up to 31 December 2009, was based on the responses from 59 organisations (68 lending teams), representing a 100% response rate of those asked to complete this year's questionnaire. The rate and detail of responses to individual questions varies between organisations due to reasons of confidentiality and availability of data. Thus, 100% response rate may refer to a different total from one question to another.

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

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

Value of outstanding loan books

A total value of £247.7bn of outstanding debt, including mezzanine finance and loans of approximately £19.4bn secured by social housing was recorded by the survey as at 31 December 2009. A further £42.5bn of loans were committed but not drawn at this date. Figure 1 shows a breakdown of this debt by category of lender and type of finance.

Figure 1: Category of lender and type of finance

Category of lender	Reported UK outstanding loans including social housing	Mezzanine	Equity	Reported UK outstanding loans including social housing, mezzanine and equity	Reported amount of committed funds not yet drawn
	£m	£m	£m	£m	£m
UK Lenders and Building Societies	158,905	394	548	159,847	32,567
German Lenders	25,972	183	0	26,155	8,249
Other International Lenders	57,454	261	25	57,741	1,562
North American Lenders	4,556	22	40	4,618	135
All Lenders	246,887	860	613	248,360	42,514

The value of outstanding debt at 31 December 2009

The debt secured by commercial property only, excluding undrawn amounts and loans to social housing, totals £228.3bn, compared to £225.5bn in 2008, an increase of only 1.2% – see Figure 2.

The allocation by lender category of the £228.3bn is shown in Figure 3.

The greatest variation between Figures 1 and 3 is the reduction in market share of UK lenders and building societies when the value of lending secured by social housing is excluded. There is a corresponding increase in the market shares of other international lenders.

On the assumption that the research captures between 90% and 95% of the specialist commercial property lending market, it is estimated that the market size is in the region of £240bn to £254bn without social housing at year-end 2009.

A feature of the data is the amount of outstanding undrawn finance of £42.5bn. This has declined from £51.8bn at year-end 2008. Approximately 57% of these undrawn amounts are held by just two organisations. Importantly, significant proportions of the value of these commitments are 'historic', having been mainly put into place between 2006 and 2008 and in conditions when both the commercial property market and lending market were far more buoyant. These loan commitments would have been for development (commercial and residential) and commercial investment projects. The lending organisations

Figure 2: Outstanding debt secured on commercial property only

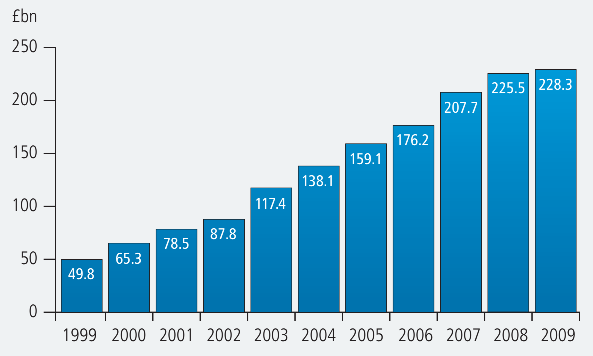
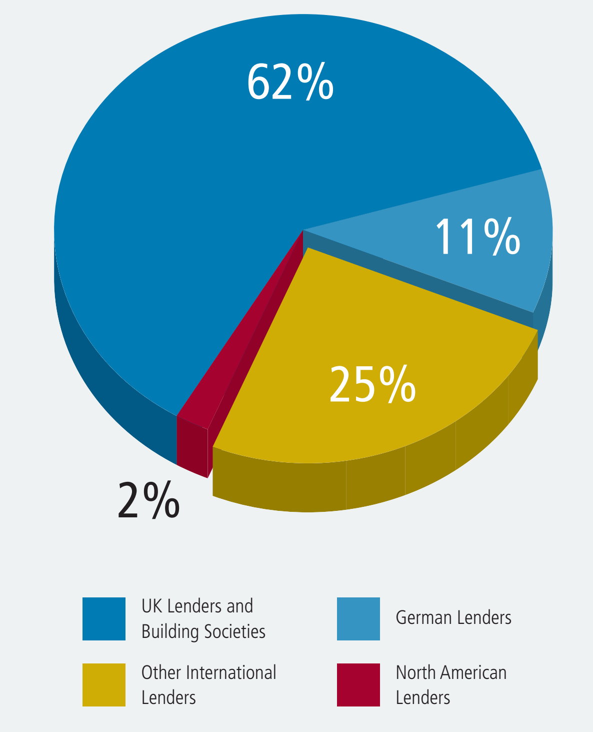


Figure 3: Allocation of drawn funding secured by commercial property



involved have to allocate the full value of the committed facility and set aside the appropriate capital under Basle II regulations. The 'borrower' will continue to pay a commitment fee of typically 50% of a drawn margin, until either the facility is drawn, the proposed project is abandoned or the commitment withdrawn. It is the general view within the lending industry that the recorded value of the committed but undrawn amounts will decline over time and this has certainly been the case between 2008 and 2009 year-ends.

In addition to the value of outstanding debt retained on balance sheet there is the CMBS market into which a number of organisations that contribute to this research have securitised packages of their loans secured by commercial property. Fitch Ratings estimates that the total outstanding balance of UK CMBS was approximately £50bn at year-end 2009.

Loan originations completed in 2009

In view of the changing market conditions, the year-end 2009 questionnaire asked for details of both new lending and extensions to loans that should have matured during 2009. Extensions to maturing loans can be recorded as new lending, refinancing or not lending in the strictest sense. Figure 4 shows the amount of loan originations, the value of extended loans that should have matured during the year and mezzanine finance, secured by commercial property and social housing completed in 2009. The value of £16.35bn includes £1.35bn of lending secured by social housing. The value of loan originations secured only by commercial property was £15.1bn, compared with £49.2bn in 2008. In addition another £12.4bn of extensions to maturing loans was reported.

A feature of 2009 was that 36% of organisations reported no 'new' loan originations whatsoever. In addition, 56.5% of the 'new' lending originated in 2009 was undertaken by organisations with a typical loan size of less than £5m. North American lenders did not undertake any new loan originations during 2009.

Relatively few CMBS transactions were completed during 2008 and 2009 and these were of a synthetic nature. Investor appetite for these securities evaporated and the issuance market came to a standstill during the summer of 2007. However, 17% of organisations confirmed that they intend to securitise loans from their loan books if/when the CMBS market recovers. At year-end 2009 these organisations held 43% of outstanding debt and were responsible for 31% of loan originations during the year.

During 2009, just over £1.1bn of debt was reported as being syndicated by 12 organisations. This represents 20% of contributing organisations. This is lower than the 32% of organisations who reported syndications at year-end 2008 and is also lower than the 34% who expressed an intention at the end of 2008 to syndicate during the following 12 months.

There still appears to be an appetite for syndications, unlike securitisations, although the amount syndicated during 2009 was only 19% of the value syndicated during 2008.

In the research, nine organisations indicated their intentions to both syndicate and securitise loans from their loan books if market circumstances allow. These nine lenders held 20% of outstanding debt and completed approximately 23% of loan originations during 2009.

Figure 4: Value and allocation of loan originations in 2009

Category of lender	Value of lending (senior & junior debt) excluding extensions to maturing loans	Mezzanine originated	Value of extensions to loans that should have matured during 2009	Total
	£m	£m	£m	£m
UK Lenders and Building Societies	9,877	51	3,862	13,789
German Lenders	2,980	–	1,279	3,939
Other International Lenders	3,495	–	6,851	10,666
North American Lenders	–	–	381	381
All Lenders	16,351	51	12,372	28,774

Importance of commercial property lending

At the end of 2009, organisations that held 74% of the £247.7bn, estimated that this lending represented 15% of their total lending in the UK, down from a high of 26% in 2006.

In relation to the value of debt secured only by commercial property this has increased by 458% from £49.8bn in 1999 to £228.3bn by year-end 2009. The rate of growth in outstanding debt in 2009 was much lower than 8.5% recorded between 2007 and 2008 and is by far the lowest growth rate recorded since this research began.

The level of outstanding mezzanine finance is insignificant, being approximately £860m, which equates to around 0.4% of the total outstanding debt. As a proportion of the aggregated debt held by those organisations that have provided the mezzanine finance, £860m equates to approximately 0.95% of all their lending.

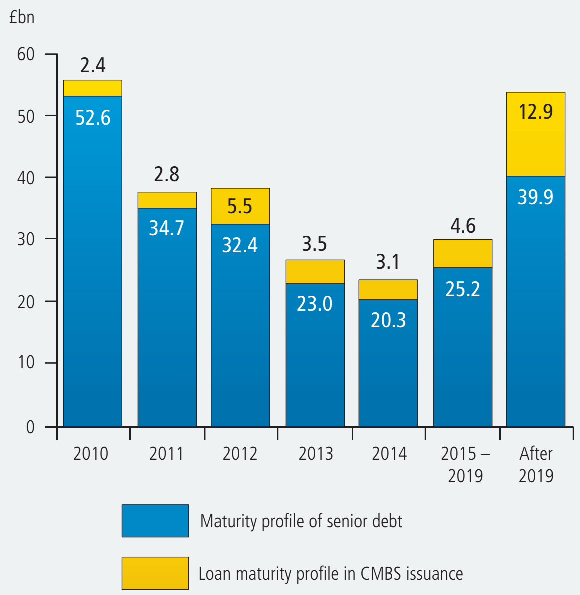
The value of outstanding debt continues to be concentrated in the loan books of a relatively small number of large organisations. The largest 12 lenders, half of which are UK lenders and building societies, have held approximately three-quarters of outstanding debt since 2002.

Debt repayment

Between 2010 and 2014 inclusive, 71% of all outstanding debt is due for repayment – see Figure 5. This proportion is higher than that recorded by previous year-end surveys for the respective following five years. For example, at year-ends 2006 and 2007, the figures were 61% and 60% respectively. Also, the volume of lending maturing in each year was distributed fairly evenly across the five-year period. This trend was interrupted in 2008 when 69% of debt was due to mature within the following five years. It is suggested that the reason for this change in maturity profile is that in many instances loans that were due to mature in 2008 and 2009 have been extended because of the borrowers' inability to refinance their loans.

The estimated proportion of loans that were prepaid or refinanced before maturity during 2009 was a mere 3% by value, compared to 13% in 2008 and an estimated 60% in 2004.

Figure 5: Maturity profile of debt secured on UK commercial property



Sources: Fitch Ratings and De Montfort University

Disposal of debt

Four lending teams reported that they had sold £179m of debt to other lending organisations at a discount (i.e. other than by syndication/securitisation at full value) and six lending teams had sold a total of £265m to third party investors.

Respondents were also asked if they had taken equity positions during 2009 in distressed loans that they held and had not reported this in other sections of the questionnaire. Nearly 20% confirmed that equity positions had been taken. However only 10% where prepared to provide data to the research. These reported that a total of £355m of equity positions had been taken.

Loan terms

Typical loan lengths

In 2009, 88% of all investment loans were written for a period of up to seven years duration, but five years was the most frequently cited loan length. The average length of an investment loan was 4.7 years in 2009, the same same as recorded in 2008, but shorter than the 6.7 years recorded in 2007. A number of respondents suggested that due to the ongoing lack of liquidity in the market, loans may remain in place for longer than the length agreed at origination.

For development projects, there has been a shift to shorter development loans. In 2007 and 2008, 52% and 48%, respectively, of development loans were for a period of two years or less. During 2009 this increased to 76% because much of the development finance available was allocated to completing projects that were already in progress.

The questionnaire for 2009 requested information for the first time in relation to the typical length of extensions given to maturing loans. For investment loans maturing in 2009, the responses showed that the range in length of extended loans was from nine months to five years. The most frequently cited length was two years. For maturing development loans, loan extensions were given for up to a period of three years. The average length of extension given was just over a year. The cost of funds and the quality and reliability of the borrower were key factors in the decision as to how long an extension to give.

Lending limits

Generally borrower limits reduced during 2009. The responses indicate that there were complex issues involved in this particular decision. Lending limits were most often related to the lending organisations' capital base and Basle II regulations. However, in practice, the attitude of individual credit committees to commercial property risk and the status of the borrower may have led to lower limits being applied.

Interest rate margins

Average interest rate margins for loans secured by all commercial property sectors generally increased between 1999 and 2002/03 but declined thereafter until year-end 2006. Increases were recorded from 2007 to mid-year 2009. The second half of 2009 saw a decrease in levels of average margins from those recorded at mid-year but the year-end 2009 average margins are higher than those recorded at year-end 2008. For example, the average margin on loans secured by prime office property increased from 213.5bps at year-end 2008 to 245.2bps at mid-year 2009 and then declined to 219.7bps at year-end 2009.

Average loan-to-value ratios

In 2008, there was a dramatic fall in average maximum loan-to-value ratios offered across loans secured by every property sector. During 2009, average loan-to-value ratios for loans secured by all prime property and secondary offices increased, for example ratios for loans secured by prime offices increased from 65.3% at year-end 2008 to 66.8% at year-end 2009. However, average loan-to-value ratios for loans secured by secondary retail and industrial sectors and residential investment continued to fall. The largest decline recorded was the average loan-to-value ratio for residential investment, from 65.3% to 61.7%.

Average arrangement fees

There has been a trend since 2005 for lending organisations to increase average arrangement fees. However, the rate of increase experienced during 2009 was less dramatic than that recorded at year-end 2008. In particular, the fees charged for loans secured by prime property and secondary retail property have levelled off or declined slightly during the second half of the year.

Average income-to-interest cover

During 2008, decreasing base rates and swap rates reduced the all-in interest costs. Together with falling loan-to-value ratios (albeit for loans secured against commercial property that had also declined in value), this resulted in income-to-interest cover ratios improving dramatically for loans secured by every property sector. During 2009, base rates remained unchanged from March, swap rates declined from mid-year and so too did the All-Property yield (source: IPD 2010). This resulted in income-to-interest cover ratios increasing but less steeply than in 2008 for loans secured by prime property and secondary office property.

The research elicited opinion as to whether terms would vary for loans of a value of £50m or above. Nearly 40% percent of organisations (the same proportion as in 2008) indicated that they could be active in the market for loans of this size.
A third of these confirmed that they would increase pricing, ranging from 25bps to 50bps on the margin. In addition, higher arrangement fees may also be charged. In contrast, 10% of organisations confirmed that interest rate margins may be reduced but only by 20bps as a maximum. The remaining organisations said that the same terms would be offered as for smaller-sized deals. Approximately 20% of organisations reported that a club would need to be in place for a loan of £50m, compared with 84% of organisations in 2008.

Extended and restructured loans

The consensus view from respondents was that where possible, extended and/or restructured loans would ideally be on the same terms as for new lending. However, the reality that most organisations found themselves in was that the process of extending and restructuring had to be undertaken on a deal-by-deal basis. In virtually all cases, the loan-to-value ratio was at a level at which the organisation would not normally lend. Few borrowers were able to inject more equity into transactions. Thus, the increased leverage accepted on extending or refinancing would be accompanied by higher pricing. The extent of the increase in pricing would be determined by the existing cash flow. Where possible, interest rate margins would be increased – the range reported was 25bps to 100bps, the latter being mentioned in circumstances where the borrower 'had nowhere to go'. However, it was also commented that decisions on pricing had to include a 'trade off' between trying to make a profit and securing repayment of money lent.

Junior debt and mezzanine finance

At year-end 2009, nine lending teams, representing eight organisations, that provided senior debt were also prepared to consider lending at above a senior debt level for prime property and two would have done so for secondary property. One team did not differentiate between junior debt and mezzanine finance and would consistently offer finance at above a senior debt level of 65% loan-to-value ratio to a maximum of 75% junior debt/mezzanine finance at an interest rate margin of 1,000bps. The data from this team is not included in the figures below.

For prime office property, at year-end 2009, three organisations were prepared to provide both junior debt and mezzanine finance. An additional two organisations were prepared to provide junior debt and three mezzanine finance only. The range of senior debt loan-to-value ratios offered by these organisations was 50% to 75%. For junior debt, the range was from 70% to 75% and for mezzanine finance, the range was from 75% to 85%. Interest rate margins ranged from 150bps to 288bps for senior debt, 350bps to 800bps for junior debt and 500bps to 1,500bps for mezzanine finance.

Hedging strategy

Organisations holding approximately 92% of outstanding debt responded to this part of the survey. They reported that 57% of the debt held had interest rate hedging in place at year-end 2009. This is an increase from 55% recorded at year-end 2008.

With regard to new loans written during 2009, 85% of organisations always require an agreed interest rate hedging strategy to be in place, compared with 77% in 2008. This appeared to reflect the view that by year-end 2009, interest rates were approaching their lowest level and that, future movements, if any, were likely to be in an upward direction.

Loans in breach of financial covenant and defaulted loans

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

Figure 6: Number and value of loans in breach of financial covenant

	Number of loans in breach	Value of loans in breach £m	Value of loans as % of aggregated loan books
2005 year-end	689	1,225	<1.0
2006 year-end	1,928	4,234	2.5
2007 year-end	1,051	1,597	<1.0
2008 year-end	3,770	10,695	6.5
2009 year-end	3,665	28,305	15.5

At year-end 2009, 88% of organisations reported that they held loans that were in breach of financial covenant, compared to 92% at year-end 2008. The value of loans in breach of financial covenant represents approximately 15.5% of the total aggregated loan book of organisations that contributed data – see Figure 6. If the proportion of 15.5% is applied to the total value of reported debt of £228.3bn, then this suggests that a value of up to £35.4bn of lending could be in breach of financial covenant.

Not surprisingly, given the decline in capital values since mid-2007, breaches in the loan-to-value covenant, at 52%, continued to be the most frequently cited cause of financial breaches. Organisations reported that the level of tenant failures had not been as widespread as expected. This with continued low interest rates has resulted in situations where even if a small number of tenants had failed, the remaining cash flow was still sufficient to service interest and capital payments.

With regards to loans that had actually defaulted, 62% of organisations reported that they had taken action to accelerate repayments, compared with 66% in 2008. The value of defaulted loans (£19.3bn) was a significant increase on 2008 but is consistent with organisations identifying and taking action on non-performing loans within their loan books. This value represents 9.6% of the aggregated loan book of those organisations that reported fully to this aspect of the research. If this proportion is applied to the total value of outstanding debt recorded by this research (£228.3bn), this would suggest that approximately £22bn of loans may have been declared in default.

With regards to reasons given for loans to be declared in default, the decline in rental income was most frequently cited. Whilst not at a level anticipated, tenant default and the inability to re-let the empty premises appear to have become more widespread. A decline in income frequently results in income-to-interest cover and loan-to-value ratios being breached. Organisations commented that action would be taken where this subsequently results in scheduled repayments of capital and interest not being made in full.

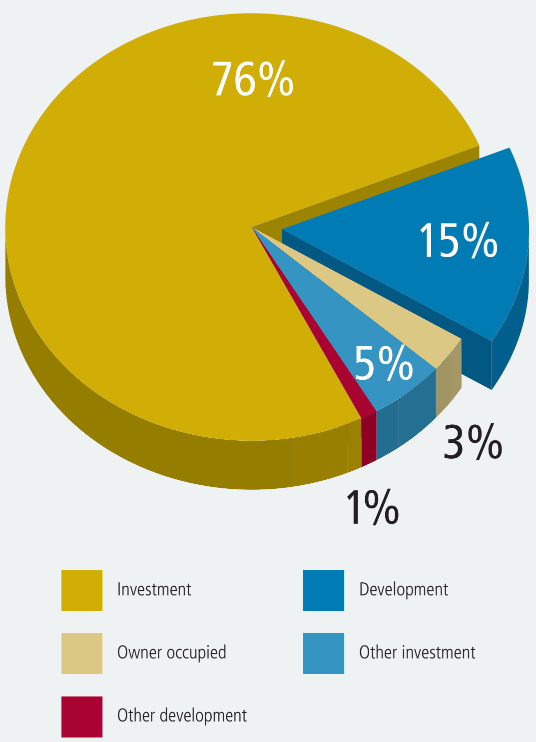
Loans secured by residential development property continued to be widely cited as an area where defaults occur. As in 2008, falls in capital values and a slow down in sales frequently resulted in cash flow problems and the failure of developers. Completed developments often had a lower value than the loan granted for purchase of the site and development. Additionally, time and cost overruns during the development period were cited as reasons for developments to fail.

Structure of outstanding loan books

Type of project

Figure 7 shows the proportion of the value of aggregated loan books that is allocated to the different types of commercial property project. The proportion of outstanding debt allocated to investment property increased from 73% in 2008 to approximately 76% at the end of 2009. Conversely the value of debt secured by commercial development fell from £16.9bn to £15.6bn over the same timescale. This is the second successive year that an absolute decrease in allocation to commercial development has been recorded.

Figure 7: Total value of lending by type of project 2009



Property sector

Comparing the results for 2009 with those of 2008, there have been small changes to specific sectors of loan book allocations. Retail, office and buisness parks, residential investment, industrial and hotels and leisure have experienced reductions in loan book allocations. This is counterbalanced by an increase in loans to investment classified as 'Other'. In particular, student housing and nursing homes and the health sector generally were cited by organisations that reported 'Other' investment lending.

Regional allocation

In 2008, over half of lending was allocated to London and the South East. However, by the end of 2009 this concentration had reduced to 45%, which is similar to that recorded at the end of 2007.

International lending

In 2009, £46.9bn of outstanding debt was reported as being secured by commercial property situated outside of the UK, compared with £53.2bn in 2008. This represents an additional amount of outstanding debt to that secured by UK commercial property.

Lending intentions

Figure 8 suggests that more organisations intend to increase their loan originations during 2010. The impact of this on potential lending activity is impossible to predict. The 26% of organisations intending to become less active only completed 12% of the value of loan originations during 2009 and 15% (of 56%) of the organisations intending to increase loan originations during 2010 completed no lending whatsoever during 2009. The intentions for 2010, therefore, indicate a positive move to re-enter the lending market. However, with an estimated £55bn of loans due to mature during 2010, the magnitude of the potential funding gap that exists in the market is clear.

Despite the current difficulties being experienced in the market, 69% of organisations continue to regard UK commercial property as an asset class against which they are willing to lend. However, this is a reduction from 73% recorded at year-end 2008 and 95% recorded at year-end 2007.

With regard to pricing, it appears that 48% of organisations altered their pricing during the last quarter of 2009. Of these, 38% increased their interest rate margins and 62% decreased their margins. The majority expectations for 2010 were that the level of pricing would be maintained or decreased. A number of respondents thought increased competition to provide loans secured by prime properties would drive pricing down.

Nearly 30% of respondents reported that their inability to distribute historic debt continued to have a negative impact on their ability to originate loans during 2009.

Figure 8: Future lending intentions

Categories of lender	Increase loan originations (%)			Maintain loan originations (%)			Decrease loan originations (%)		
	2008 year -end	2009 mid -year	2009 year -end	2008 year -end	2009 mid -year	2009 year -end	2008 year -end	2009 mid -year	2009 year -end
UK Lenders and Building Societies	21	39	40	17	28	25	63	33	35
German Lenders	38	75	75	38	19	19	23	6	6
Other International Lenders	20	40	62	27	13	5	53	47	33
North American Lenders	–	40	25	60	20	50	40	40	25
All Lenders	23	50	56	28	20	18	49	30	26

Conclusions

2009 was a year of consolidation across the UK commercial property lending market during which little new business was done and attention was focused onto getting existing loans into better shape. Consolidation was seen within individual organisations as well as across the categories of organisations that participate in the research. New lending activity was at the lowest value recorded by this research, whilst the volume of loan impairments was at its highest. The impact of the sheer volume of the over-hang of property debt is likely to be felt for some time.

The volume of loan extensions undertaken during 2009 has resulted in £52.6bn of debt retained on balance sheet being due to mature during 2010 and a total of £120.7bn by year-end 2012. In many instances, maturing loans continue to be extended. At year-end 2009, the typical length of an extension was between one and three years.

Many organisations spent much of 2009 investigating their existing loan books to identify non-performing loans. However, even in cases where loans have defaulted, the assets securing the loans are not necessarily placed onto the market for sale. In many instances, lending organisations are willing to retain and manage property assets in the hope that they can eventually be disposed of in an improving market.

The biggest issue facing the industry is the severe lack of liquidity with which to finance commercial property lending. A combination of extending maturing loans, restructuring distressed loans and meeting Basle II capital requirements, all resulted in lending organisations hoarding liquidity. Additional hurdles to increasing liquidity are the £42.5bn of committed but undrawn amounts and the inherent issue of 57% of outstanding debt having interest rate hedging in place. For distressed loans, the unwinding of interest rate swaps is a real and extra cost that has to be met from the sale proceeds of an asset – but most capital values are below those prevailing at loan origination.

Opinion, whilst divided, has been expressed that the only real solution to the liquidity problem is for organisations to get impaired loans off their balance sheets, absorb the losses and to start lending again. It is recognised, however, that such an approach will also absorb capital and will not result in the volumes of lending seen in the recent past. The alternative is to plan for a slow recovery process, with some organisations reporting that it will take between five years to 10 years to repair their loan books. The prospect for a swift and painless recovery in the market is unrealistic. A sometimes painful but conservative and risk-adverse approach to lending, driven or restrained by the prospects for growth in the UK economy, appears the best that can be hoped for.

Where's the investment supply going to come from?

Stuart Morley,
Director and
Head of Research,
GVA Grimley Ltd

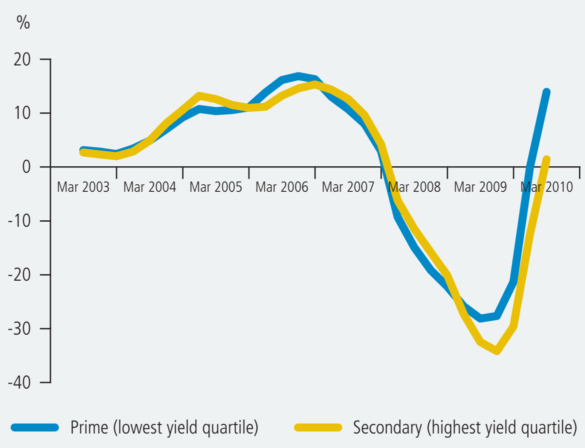
Dan Francis,
Associate,
Research,
GVA Grimley Ltd

Commercial property values, on average, have risen 15% since their low point last summer and prime property, particularly in central London, has seen even larger increases of up to 30%. The main reasons for this somewhat surprisingly healthy performance are strong demand from investors but also a marked lack of supply. Demand has been strong as yields a year ago were very high in absolute terms and relative to the yields on alternative investments. The effect of a weak pound also made UK property particularly attractive for overseas investors.

This article concentrates on the potential supply of investment property – what is owned and by whom, its quality, how much is likely to be sold and when it might be sold – to see how the supply/demand imbalance might change in the short term.

Institutional and private investors are keen buyers rather than sellers of property, although some have recently sold properties that they bought last year to benefit from the recent uplift in prices. The main potential sources of supply over the next few years are therefore the banks and the public sector, with some potential from the corporate sector (sale and leasebacks) and from new development.

Figure 1: Prime vs secondary capital value growth



Source: IPD, GVA Grimley

The banks – stick or twist?

The total amount of outstanding bank lending to UK real estate is huge, at over £220bn, and as a result of the exuberance of the investment boom during 2004-08, the banks have a considerable exposure to secondary property. Although a high proportion of properties on banks' loan books are in 'technical' breach of their loan-to-value covenant, most are not in outright default. In these cases, banks are generally taking little action as long as the rental income covers the interest charges.

Where some or all of the interest or principal is not being paid, the bank can either force a sale of the asset, or can take ownership (or part ownership), and attempt to increase the income generated. The decisions made by the banks on how to deal with 'distressed assets' will have a major influence on the commercial property investment market over the next few years. So what will influence the decisions that banks must make on these assets?

At the individual property level, the quality of the physical asset and its covenant strength are key. Prime and good quality secondary assets are still attracting significant buyer interest and selling an asset now may therefore be an attractive option. However, at the more secondary and tertiary end of the market, buyer interest remains limited. Also important are the scope to increase the income of a property through better management, the level of outstanding debt relative to the current property value, and how close a loan is to maturity.

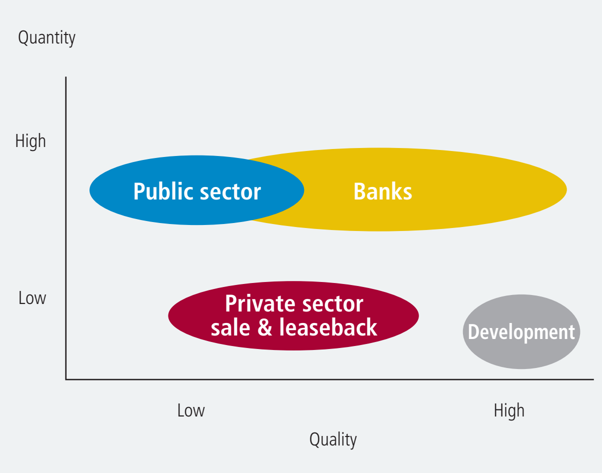
Individual banks have been formulating strategies for their 'distressed' portfolios and for most, the process of planning what to do with their problem assets is now completed. The policies adopted depend in part on how they view the outlook for the property investment and occupier markets. However, policy regarding future exposure to the commercial property sector will also be important, and will be influenced by their financial position. Some banks will be planning to exit the market, whilst for others; a continued long-term relationship with borrowers is core.

The banks will react to any changes in occupier and investment market conditions. In addition, the overall level of refinancing for the UK commercial property sector as a whole required during 2010 is huge and the availability of finance will still be limited. This will result in the sale of some properties more at the secondary end of the spectrum, but the re-financing of many loans are likely to be delayed and the existing loans extended.

Ultimately, what will the banks do? They are certainly more likely to sell any prime properties they hold that are distressed, as this is where investor demand is currently high. However, the actual amount of property released will be limited, as prime assets are less likely to be distressed than secondary/tertiary assets. However, the majority of 'distressed' properties will be of poorer quality, on which the banks lent substantial amounts of money during the later stages of the property boom, as these will have the weakest covenants and be harder to re-let as leases come to an end.

In some cases, a bank will become a 'forced seller', although this should be the exception rather than the rule. In most cases, the banks should be able to turn on and off the tap of properties coming to the market as they see fit, meaning a steady flow of properties coming to the market over a period of several years. We expect an increase in supply coming to the market over the next year, and this will be a broad mix of quality. However, a flood of properties entering the market through this route appears unlikely.

Figure 2: Sources of supply – quality vs quantity



The public sector – what will it sell?

The government estate has a total book value of £386bn according to the Office for National Statistics. Of this total, the central government estate accounts for around a third, with the remainder comprising local government property, of which around half is council housing. The estate is extremely diverse, encompassing a full range of property types, land and infrastructure assets.

Disposing of surplus property assets has long been an integral component of government asset management strategies, but recent years have seen greater emphasis placed on achieving efficiency gains leading to asset sales. HM Treasury's Operational Efficiency Programme (OEP), which was launched in 2009, estimated the potential for savings from improved efficiency over the next 10 years to be around £20bn in receipts from property disposals (excluding council housing). It also recommended the establishment of a central property unit to drive through change.

The unit is now up and running but has yet to make any specific announcements regarding the release of property assets. The new coalition government has, however, called for the creation of a central management model for property ownership as well as the increased privatisation of government property. The new unit is likely to consider alternatives to straight-forward asset disposals, such as state-sponsored REITs and encouraging sale-and-leasebacks and other joint venture agreements with the private sector.

Richard Levis, Senior Researcher, GVA Grimley Ltd

The preceding government's Total Place Initiative, is emerging as a new strategy likely to influence future local authority asset management strategy. Following the results of a recent pilot, a March 2010 HM Treasury report estimated that, at the national level, the Total Place Initiative could generate up to £35bn of gross capital receipts over the next 10 years from the sale of surplus assets to support OEP targets. Further work is currently underway to establish the viability of the initiative at a number of local authorities.

Andrew Screen, Head of GVA Financial Consultancy Ltd

Running in parallel with the recommendations of the OEP, in the 2009 budget the previous government detailed plans for the sale of £16bn of assets over the period 2011-14. Central government's share of this total is £5bn, £3bn from real estate, with local authorities expected to find £11bn. The plans have been carried forward by the new coalition government, but are likely to change following the emergency budget in June and the comprehensive spending review in autumn. Considering the existing rate of asset disposals under previous spending reviews (£4bn pa), the current plans do not represent a substantial increase in 'background' levels.

With further pressure to improve efficiency, most local authorities will be forced to consider further outsourcing, sharing of facilities between authorities, cutting services where possible, hot-desking, home working and how they can reduce the space they occupy and use it more efficiently. This may well mean investing in new or refurbished buildings with larger (more flexible) floor plates and disposing of older, smaller, less efficient buildings.

Establishing the business case for such 'invest to save' initiatives will be difficult where disposal values are low. But the scope to reduce property running costs is significant, especially where high maintenance backlogs exist. In addition, increasing energy and carbon costs will also play a part in decision making.

A major difficulty with government plans for property disposals is that the recent property downturn will make local authorities reluctant to sell at what is considered to be close to the bottom of the market, particularly for the more secondary property that local authorities would want to dispose of. Conversely, rather then selling off buildings or sites, many local authorities may be more likely to consider acquiring property sites and redeveloping or refurbishing existing buildings, taking advantage of lower prices and low interest rates, to achieve longer term floor space efficiency aims, so saving on future rental payments. In addition, some local authorities argue that freehold ownership gives them greater control over the use of buildings they occupy.

A contrary view is that having to pay rent concentrates the mind and provides a constant pressure to use space efficiently. The opportunity for local authorities to sell assets they own and occupy, and lease them back, as a way of realising capital receipts, has its attractions and newer, well located property, subject to a long lease back to a local authority, would be attractive to investors and high prices would be payable in the current market.

In summary, under current plans local authorities, health trusts and central government departments are not likely to immediately increase disposals significantly above current trend levels. But with deep cuts to government spending imminent, the need to make ever more efficient use of public sector property is becoming a priority. This may result in a significant increase in disposals over the medium term, but the types and locations of sites that become available will have only a limited impact upon the commercial investment market. However, we do expect to see an increase in sale-and-leaseback transactions and other joint venture agreements with the private sector. We also expect to see an increase in multi-asset development joint ventures with delayed land/asset disposals as the public sector seeks to make its assets work harder and benefit in the development profit.

Private sector sale and leasebacks

Around half of the UK commercial property market is owned by investors, so the other half is therefore available potentially for a sale and leaseback, though of course in practice not all of this will be. However, the scope for this area as a potential source of a large volume of investment supply would appear to be very considerable.

In the present climate, where many corporates are under pressure to improve the position of their balance sheets, a sale and leaseback has the potential to raise debt finance which might otherwise be difficult to obtain. And there are many other generic benefits for occupiers, although at the individual organisation level there may be barriers to such an approach.

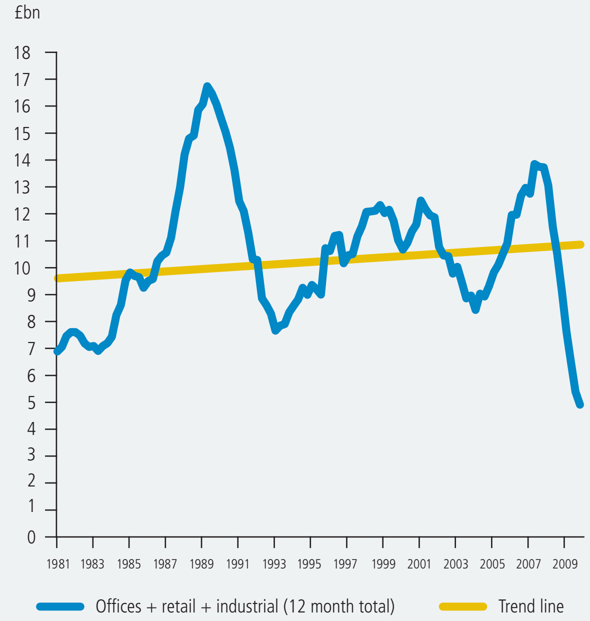
For investors, the quality of portfolios owned by corporates is a significant issue, and this, rather than a willingness of corporates to consider sale and leasebacks, will be the key limiting factor. Whilst it is difficult to judge the level of supply that might come forward from private sector sale and leasebacks, we are optimistic that this will provide a valuable source for investors over the next few years.

New development

The recent property investment boom did not see the surge in development activity that characterised the late1980s/early 1990s period, although activity still increased to a level well above trend. However the collapse in activity over the last two years has been dramatic.

The value of new construction orders (a proxy for the level of construction activity at the start of the development process), measured in real terms, has plummeted below the levels seen at the depths of the early 1990s and early 1980s recessions. This is even more striking when one considers that the UK economy and property market have expanded considerably over the last two decades.

Figure 3: New construction orders (2005 prices)



Source: DTI, GVA Grimley

The extent of the collapse in construction starts, poor viability and the lag between starts and completions will inevitably mean that only a very limited supply of completed new build investment opportunities are brought to the market over the next few years. New build development is not likely to be a major source of properties coming to the market, but forward sales and forward funding opportunities will be more plentiful, although this will depend on how quickly occupier demand and rental growth performance improve.

We expect the new Treasury Infrastructure Finance Unit (TIFU) and tax incremental finance (TIF) initiative to stimulate new development in the medium to long term, while several private equity houses are currently setting up infrastructure funds or providing senior debt.

Conclusions

Our research suggests that there should be a steady flow of properties from the banks coming to the market over the next few years, but this will be in a controlled manner. A flood of properties entering the market seems unlikely and the quality will be mixed.

In the public sector there could be a significant increase in asset disposals, as the spending cuts take effect, but disposals are likely to be older, smaller, sub prime properties which will have limited appeal to the private investment sector unless they are subject to a public sector leaseback, or other public-private joint venture.

New build development is not likely to be a major source of properties coming to the market, due to the very low level of recent development starts which is likely to persist due to the relatively muted economic upturn and the restricted availability of bank finance. Where new development does occur there will be opportunities for institutional funding through forward sale agreements. This will increase investment supply but the amount of development will depend on improved occupier demand and positive rental growth, both of which look uncertain at present.

Demand for prime and near prime investments remains strong, but less so than it was three or six months ago due to the major hardening of yields that has occurred over the last 12 months. Arguably in early 2009 prime property yields had over corrected, were well above long run average levels and there was a huge positive yield gap over gilts and equities therefore providing a 'once in a lifetime buying opportunity'.

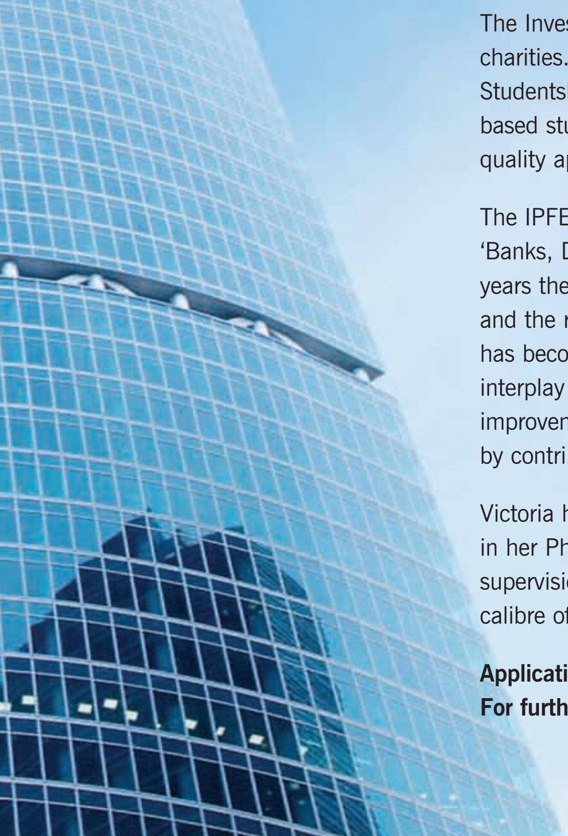
Now property seems more fairly valued. Compared to gilts and equities, property yields still look relatively attractive, income is stable and restricted development means limited new supply over the next few years. However, rental growth will be negative in the short term and the prospects for a strong, quick occupier upturn seem remote due to major cuts in the public sector plus tax increases.

Income growth prospects remain poor in the short-medium term, so investment demand is likely to stabilise or weaken slightly, just as investment supply gradually increases. Static capital value growth at best and low investment returns seem likely over the next 12 months, before a more normal market returns in the latter half of 2011.

NOTE: This article is an edited version of the GVA Grimley bulletin of the same title, published in Spring 2010.

Investment Property Forum Educational Trust

Patron Sir John Ritblat



IPF Educational Trust (IPFET) PhD Studentship Programme

The Investment Property Forum Educational Trust (IPFET) is one of the leading property industry charities. Earlier this year, the IPFET launched a brand new PhD Studentship Programme. The Studentship provides University fees and stipend for a full time PhD and is open to UK and UK-based students undertaking a PhD in real estate. The Studentship is an investment in a high quality applicant with a relevant, viable, enduring research topic.

The IPFET PhD Studentship 2010 has been awarded to Victoria Ormond. Her PhD is entitled 'Banks, Debt Covenants and the Real Estate Sector; From Courtship to Crunchtime'. In recent years the commercial real estate market has suffered significant loan defaults and refinancing, and the relationship between the banking and real estate sectors and the regulatory environment has become increasingly complex. Victoria's research will provide a greater understanding of the interplay between these three key inputs to debt provision and intends to result in 'an improvement in the functioning and efficiency of the commercial real estate private debt sector by contributing to better lending practices and more sophisticated, risk sensitive loan design'.

Victoria has previously worked for the Royal Bank of Scotland where she developed her interest in her PhD research area, and will now research at the University of Cambridge under the supervision of Dr Jamie Alcock and Professor Colin Lizieri. The IPFET are delighted with the calibre of applications for the Studentship and look forward to an ongoing successful programme.

Applications for the IPFET PhD Studentship 2011-2012 will open in January 2011.
For further information, contact Vicki Law – vlaw.ipfet@googlemail.com

Property investment: A new landscape

Report from the IPF Conference in Scotland, 9 June 2010

The seventh annual IPF Property Investment Conference in Scotland, sponsored by Scottish Widows Investment Partnership (SWIP) and Miller Developments, took place in Edinburgh on 9 June. The speakers, all leading industry experts, underlined the challenges facing the property industry and economy as a whole in the next 12-24 months and the changes we are likely to see as a result. The event was chaired by IPF Scotland Chairman, Graham Sanders of Sanders Cartwright.

Welcoming everyone to the conference, Malcolm Naish, Director of Property, SWIP said that the last five years had been an extraordinary period. In his view, "some of the greatest challenges are yet to come".

John Gellatly

John Gellatly, Head of Europe – Real Estate Multi-Manager, Aviva Investors and the IPF's incoming National Chairman, agreed with Malcolm and said he thought the investment outlook generally was not hugely positive, "it is going to be really bad, or not so bad". While theoretically there is some growth in the economy and we have historically low interest rates, the situation in Greece has led to considerable downgrading of expectations. He was concerned about what was going to happen when quantitative easing finished and rising unemployment figures once the public sector cuts took effect.

The UK has a mature and liquid property market, which is why it attracts so much overseas investment. However, the market was likely to get tougher for a number of reasons, not least because the German open-ended funds will be subject to more stringent liquidity regulations and so are unlikely to be such large investors in direct property going forward. Coupled with this, we are going to see rising bond rates, and potentially interest rates and an increasing level of regulations, through Basle 11, the AIFM Directive etc. However, compared with equivalent gilts, he thought property would look reasonably attractive, especially if one thinks there is an inflationary risk.

In terms of specific property sectors, the Aviva funds favoured shopping centres and retail warehousing over standard retail, which was "fraught with difficulty". John thought that Central London offices were a "three-year play, with the market turning down in 2012" but he liked the high cashflow yields from industrial.

Lucy O'Carroll, Senior Economist, Lloyds Banking Group, said the global economy was returning to growth, the UK having experienced a period of severe recession. However, there were some significant uncertainties, including the timing, scale and impact of deleveraging by businesses and households, and the effects of the government's fiscal squeeze.

Lloyds Banking Group's base scenario for the UK economy envisages a return to growth this year, followed by a fairly anaemic period of expansion out to 2014 as the potential for a stronger post-recession rebound is offset by deleveraging and fiscal tightening. Given the uncertainties, however, there is a significant risk of a double-dip.

One of the problems she foresaw was that,"almost all countries are trying to export their way out of recession at present – but if we all try to do that, the only way we can all succeed is by exporting to Mars".

With regard to property, there was evidence of polarisation in the market, with a stronger recovery in London, for prime property and for major businesses/fund managers. On the basis that confidence spreads more widely through the market, capital values can be expected to continue increasing at a modest pace out to 2014, following this year's recovery. However, "a sustained performance from the property market depends on continued recovery in the wider economy".

The outlook for the market is also very dependent on the prospects of the banks lending again. Max Sinclair, Head of UK Division, Eurohypo said he thought that 2009 should prove to be the low point for new property debt origination but the situation was still difficult. There is a funding gap of at least €40-45bn in the property market and the problem is compounded by the £50bn of debt, according to the De Montford survey, due for refinancing in 2010, with further large sums in 2011 and 2013.

Conference speakers (left to right): Ian Watson, Andrew Smith, John Gellatly, Max Sinclair, Graham Sanders, Lucy O'Carroll.

So what is going to happen? 2010 is likely to prove very slow, with liquidity in the banking market declining, 60-65% loan-to-value remaining the norm, loans over £100m being in "a rarefied atmosphere", and bankers being very reluctant to lend on anything that is not prime property. Interest rates are likely to stay low over the long term but for the markets to free up, there needs to be a reduction in pricing in most stock – providing buying opportunities into 2011.

The supply of debt for the property market will, however, remain constrained until the banks are recapitalised, as they cannot take the losses from selling property until then.

Andrew Smith, Global Head of Property, Aberdeen Asset Management described the last 10 years as "a lost decade" for property investors as capital values in nominal terms were back to those at the beginning of 2000 and in real terms they were negative. However, institutional and retail investor demand has rebounded rapidly as UK property looks attractive compared to both other property markets and other asset classes. Overseas investors are particularly enamoured with the "large shiny offices in Central London", accounting for over three-quarters of investment in this sector.

He said the retail sector particularly was still finding the market tough. Some retailers, not least Woolworths, have disappeared and those remaining are experiencing increased competition from internet sales, out of town centres and the supermarkets taking a larger share of the non-food sector.

Like Aviva Investors, Aberdeen thinks the property market will remain relatively attractive compared with the equity and bond markets.

The debt crisis has changed investor behaviour: there is less appetite for risk, investors want greater control and a greater alignment in interests between the investors and fund managers. He thought the greater risk aversion was likely to be temporary but other changes would be long lasting.

The final speaker, Ian Watson, Joint Chief Executive, Hansteen Holdings, considered the legacy of the credit crunch and the need for countries, banks and individuals to de-gear. He thought that we could be in for, "a long period of grisly, grinding difficult times", with the next couple of years feeling more like a recession to most of the UK than during 2008-09, particularly as the fiscal stimulus will be reversed at some time.

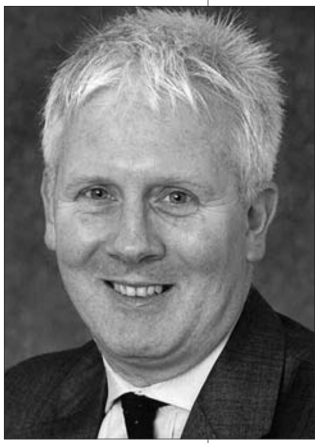
There will be no rental growth for quite a period so property yields are likely to move out. Nothing will be settled until investors decide what IRR they can live with – in Ian's view, a total return of 8-12% ought to be achievable if one buys sensibly. He sees this market as an opportunity for property professionals who understand property and tenants and can buy at forced sale values and/or where there are high vacancy rates.

Graham Sanders

Graham Sanders, Chairman, expressed the view that the position on rents and rental values was understated by the market, particularly in the retail and office sectors. With the growth of online shopping and the substantial incentives required to achieve lettings, this will be the main factor contributing to a drift in capital values in the next 6-12 months.

The key message from the Conference is that returns from property over the next few years are likely to be relatively attractive compared with equities and gilts. However, these returns will not come easily and careful sector selection and active asset management will be essential pre-requisites in achieving them.

Institutional investors – are they going to change their approach to property?

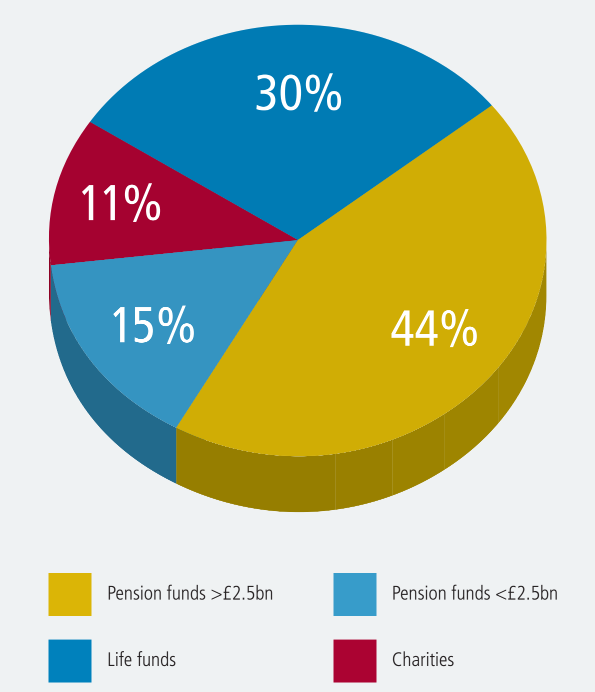


Paul Mitchell, Paul Mitchell Real Estate Consultancy

A new report undertaken for the IPF's Research Programme explores the types of property strategy adopted by UK institutional investors and how these are likely to evolve in the wake of recent market turbulence. The research, undertaken in conjunction with INREV, involved in-depth interviews with 40 pension funds, insurance company life funds and charities whose £447bn of total assets represented about two-fifths of the universe's capital.

Figure 1 illustrates how the large pension funds and the insurance company life funds dominate property investment within this universe. Not surprisingly, there were a range of property strategies being followed by these investors. This article outlines the themes identified.

Figure 1: Estimated UK institutional property universe by type of investor

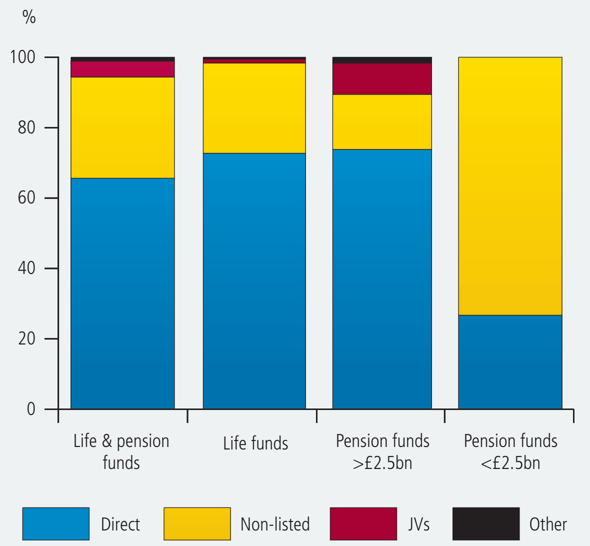


A preference for directly-owned property

As Figure 2 illustrates, most institutional investment is through direct property. This reflects both the dominance of the life funds and the big pension funds in the UK institutional universe and, according to the interviews, a strong preference, wherever practicable, for the control and influence which a direct portfolio provides. Taking the direct route is not a viable option for the small to medium-sized pension funds and charities where investment in property is primarily through non-listed funds.

Even so, and emphasising this preference for direct, some small investors have direct portfolios of less than the £100-150m, which investment consultants believe is normally the minimum necessary.

Figure 2: Estimated UK insitutional universe by type of property

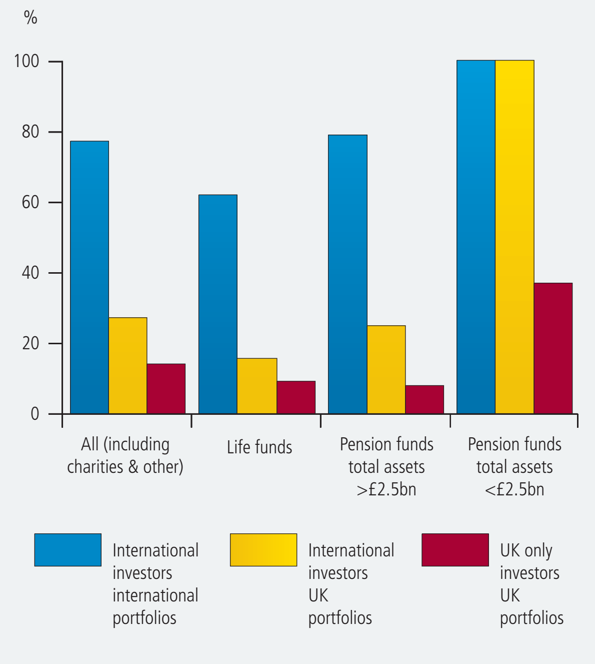


Divergent attitudes towards non-listed funds

While having predominantly direct portfolios, most life funds have significant exposures to non-listed funds. Some large pension funds have also embraced non-listed funds enthusiastically; diversification being their primary rationale. In this respect, non-listed funds are used in two ways; first to enhance their predominantly direct UK property portfolios by providing access to out-of-reach or specialist sectors, and second to lower the risk of the multi-asset portfolio by providing an exposure to international property. As Figure 3 reveals, non-listed funds are the main route by which investors get this international property exposure. According to the investors in the survey, superior returns are a less widespread motivation in using non-listed funds.

Figure 3 also reveals how cross-border investing in UK institutions is heavily intertwined with attitudes to non-listed funds. Generally, those investing internationally have a higher exposure to non-listed funds than those restricting their property investments to the UK. Those investors with negligible exposures to non-listed funds and not investing internationally have a different investment philosophy to the majority for whom a well-diversified property exposure is central. They consider that multi-asset portfolio diversification can be attained more efficiently elsewhere, such as through hedge funds; that the returns are not

Figure 3: Average proportion of non-listed property in UK institutions' international and UK property portfolios



worth it given risk, illiquidity, and governance issues; and/or have a very specific return requirement for property that, in their eyes, would be corrupted by a non-listed and cross-border exposure. These investors represent a significant minority of UK institutions.

There are also those who avoid specialist funds because they prefer to get access to out-of-reach or specialist sectors through joint ventures, which are perceived to offer superior control and alignment of interest. For this group, joint ventures are very much an alternative to non-listed funds, a view backed up by the observation across the survey that those with low exposures to non-listed funds had relatively high exposures to joint ventures. This explains the relatively high exposure to joint ventures amongst big pension funds illustrated in Figure 2.

These investors who have a longstanding antipathy towards using non-listed funds are now being joined by some who have become disenchanted, given recent performance. In particular, they are expressing regret over unforeseen risk, unfulfilled liquidity, lack of control, and misaligned interests, both with fund managers and co-investors. Overall, more investors in the survey were planning to reduce the proportion of non-listed investments in their property portfolios than were anticipating an increase. Not surprisingly, there was a desire to see less gearing in non-listed exposures.

The focus of such a reduction in investment in non-listed is typically UK specialist funds. At the same time, there was a greater desire to invest directly in sectors previously perceived to be out of reach or where the expertise to invest directly had been thought to be lacking. Such investors were happy to compromise the diversification benefits that had originally justified the non-listed approach. Joint ventures were also being considered by more as an alternative to specialist non-listed funds.

The research provided some interesting insights into the strategies being adopted by small to medium-sized pension funds. Although most traditionally have gained their property exposure through a domestic balanced non-listed fund, there was evidence of a wider range of strategies being adopted. These investors are particularly interesting as most institutions investing in property for the first time come from their ranks and they are not necessarily bound by traditional approaches to property investment. Notably, there were examples of smaller pension funds with much higher (percentage) exposures to international property in percentage terms than their bigger peers – in some cases 50% of their property holdings, compared to the typical 10-20% in the larger institutions. Their strategies involved either appending an exposure to a separate UK balanced fund, or taking an integrated pan-European or global approach. The latter, according to some investment consultants, is becoming the norm in new mandates.

Changing attitudes towards listed property

There were also some indications of changing attitudes towards listed property. Very few investors in the survey could invest in REITs and listed property companies as part of their property allocation: such exposures were typically part of the equity allocation. However, one investment consultant reported significant interest – but little take-up to date – across new mandates in 'cheap and liquid' beta strategies based on REITs and listed property companies.

Conclusions

There are four important conclusions from the research. First, institutional exposures to property are set to increase as pension funds restore their allocations to strategic levels and those looking to invest in property for the first time return to the market; such investment, however, would be partly offset by the insurance company life funds reducing their exposure.

Second, exposures to specialist funds are likely to reduce as the life funds, which have relatively high exposures, generally reduce their property investment and as disillusioned big pension funds shift towards direct and joint ventures.

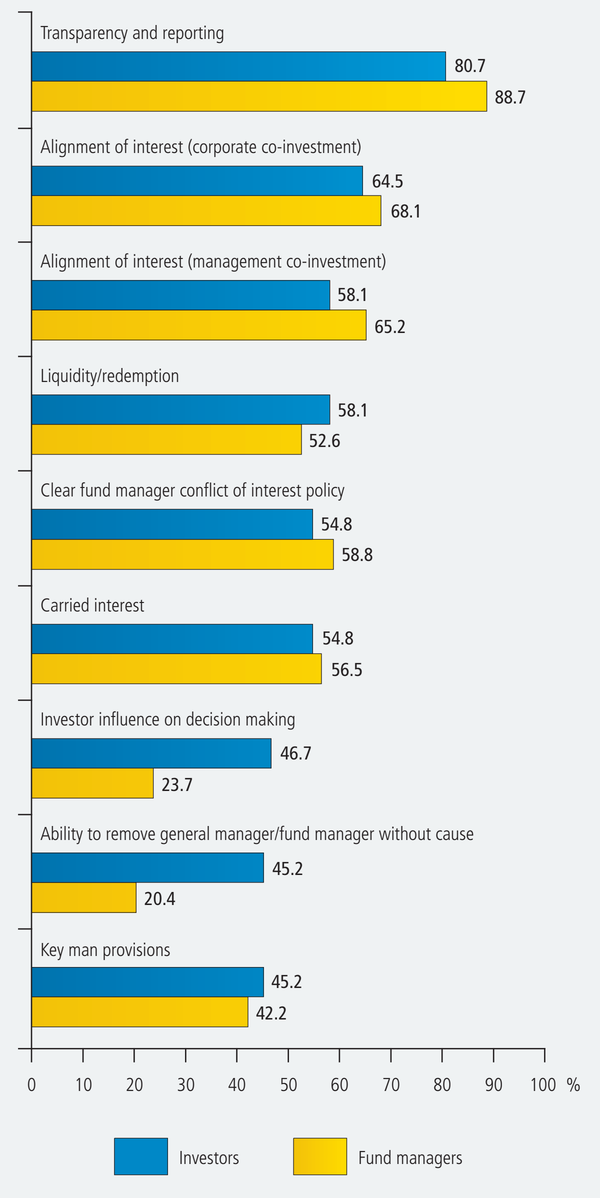
Third, international investing is set to increase relatively quickly. Although most investors were attaching short term priority to the UK, the majority were committed in the longer term to an international property strategy. This should lead to an increased focus on non-listed funds and help offset the shift out of specialist funds.

Finally, the indications are that a significant minority will continue to eschew investments in non-listed funds and international property, focusing instead on a core UK direct exposure and looking in other asset classes for diversification and superior returns and risk.

Making real estate funds more investor-friendly

Investors have been disillusioned with real estate funds. The recent economic climate has highlighted the lack of liquidity, lack of control for investors and a misalignment of the interests of fund managers and investors. With the economy showing signs of stability some of the numerous funds being promoted are beginning to close. Lessons have been learnt and the terms on which funds are being promoted are looking more investor friendly.

Figure 1: Percentage of respondents who ranked the following key terms either 1 or 2 according to their importance/ perceived importance when investing in a real estate fund



In March 2010, the Indirect Investment team at Nabarro LLP surveyed its clients and contacts in order to gauge opinion on the current trends and challenges in the real estate market. This article looks at some of the survey results.

Deborah Lloyd, Partner, Nabarro LLP, and a member of the Management Board of INREV.

Key investment terms

Fund transparency and open communication between a fund manager and its investors has always been of major importance. Increasingly investors are insisting on transparency between themselves, wanting to know special fee arrangements or terms for larger investors and who they are investing alongside, so they can be reassured there is a common investment philosophy and ability to fund future draw downs.

Alignment of interest was also very important with investors, who made little distinction between co-investment by the corporate fund manager entity and co-investment by individual senior executives. The key seems to be that the amount of the co-investment must be a meaningful amount to the organisation or individual.

On the majority of issues, fund managers are in tune with the expectations of investors. However, as shown in Figure 1, fund managers underestimated the importance to investors of investor influence on decision making and the ability to remove the fund manager without cause. It is becoming increasingly difficult for a fund manager to resist 'no-fault divorce' provisions (when investors decide to remove the fund manager by, say, an 80% vote). A fund manager may seek to limit the applicability of such a term and its impact, for example, by preventing its application in the first two years of the fund and by requiring the payment of an additional 12 months' management fees. There also needs to be agreement on what happens to the fund manager's co-investment and entitlement to carried interest.

Investment criteria

Not surprisingly, the survey found a fund's rate of return is the most important investment criterion for investors (see Figure 2). The type of fund (core, value-added, opportunistic) is also important as it identifies the investor's appetite for risk. Investors place less weight than fund managers envisage on taking advantage of current market conditions and the diversification of investment portfolios. Among other investment criteria cited by respondents as important were the investment performance, track record and reputation of the fund manager, gearing levels and attitude to leverage and liquidity. One investor respondent commented: "We must like them and trust them with our cash!"

Figure 2: Percentage of respondents who ranked the following investment criteria either 1 or 2 according to their importance/perceived importance to investors when investing in real estate funds

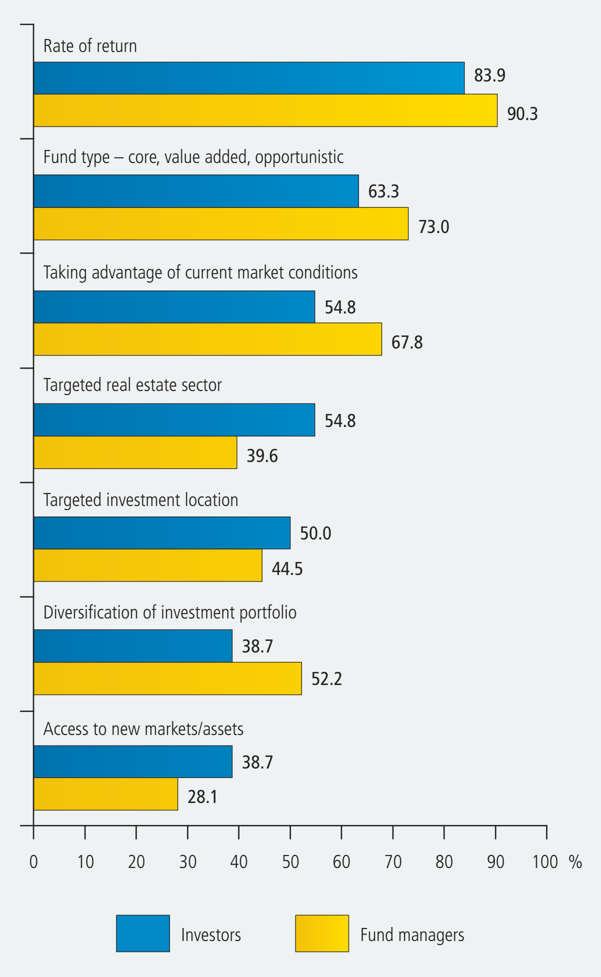
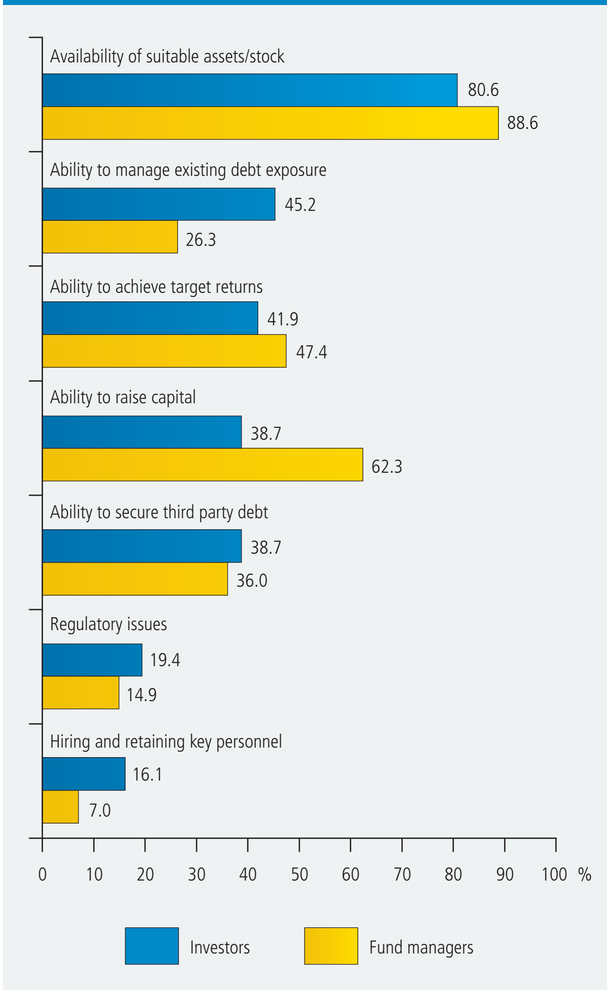


Figure 3: Percentage of respondents who selected each factor as one of the three factors they consider as presenting the biggest challenges for real estate funds during 2010-11



The challenges

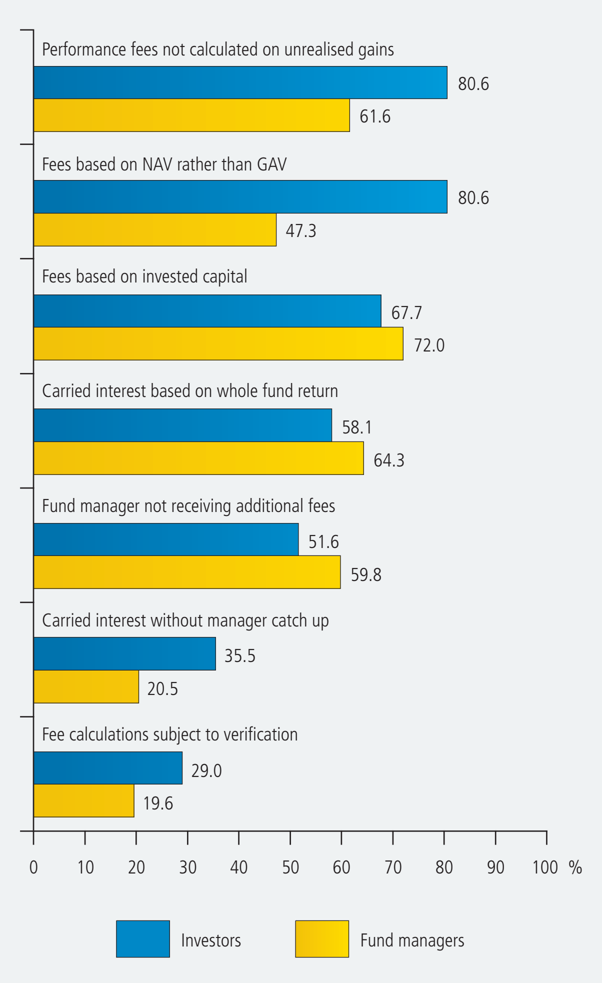
Respondents were asked to select which three factors they thought would present the biggest challenges for real estate funds over the coming year. As expected, the overwhelming consensus is that the availability of suitable assets and stock will be the biggest challenge with over 80% of both fund managers and investors citing this. Significantly, investors see the ability to manage existing debt exposure as a major challenge: although this does not seem to be recognised by fund managers. The biggest divergence between fund managers and investors is over the ability to raise capital going forward: fund managers see this as a major challenge, reflecting their current experiences, while investors view this as a lesser challenge. Perhaps investors' views reflect their own investment intentions for the year ahead. The full results are shown in Figure 3.

Investor requests

In line with investors wishing for more transparency and reporting, the survey showed that written updates on strategy are the most commonly made investor requests (with a result of 88%). Whilst a large percentage of investors have requested reduced management fees as a first close investor (71%), far fewer fund managers reported receiving this request (36%), suggesting either fund managers are in denial or that this may be a fairly recent trend that we will see more of in the year ahead.

Interestingly, a significant proportion of investors (67%), and more so than envisaged by fund managers (46%), want to know who their fellow investors are. Investor approval rights are also high on investors' agendas (63%), and are more important than fund managers realise (40%).

Figure 4: Percentage of respondents who consider each of the following to be a common position regarding fees in the current market



Fund manager respondents noted that investors are generally carrying out much more rigorous due diligence than previously.

The current thinking on fees

The two big issues are: fund manager's performance returns to be based on realised returns and a preference for NAV rather than GAV to be the basis for management fees.

Hostility to GAV fees is a backlash to the recent fall in NAV and comparatively high fees paid against equity invested. In practice, NAV coupled with a base fee or fees based on drawn equity is more the norm. However, it is difficult to determine what is 'common' in the market where so few funds are successfully launching. Figure 4 shows what respondents consider to be a common position regarding fees in the current market

Conclusion

Today's investors are wiser, having experienced the operation of real estate funds during unstable market conditions.

Nabarro LLP's experience of acting for both fund managers and investors and the results of this survey has highlighted that institutional investors are now more selective about where they commit funds. Once a fund manager has demonstrated a credible track record, investment strategy, asset pipeline, investors seek:

- robust alignment of fund managers' and investors' interests;
- comprehensive corporate governance; and
- increased fund manager accountability and transparency.

A full copy of the survey can be obtained from www.nabarro.com/Downloads/9321.pdf

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IPF Survey of IFAs June 2010

Louise Ellison, Research Director, IPF

The second round of the IPF Survey of IFAs for 2010 shows a sharp reduction in the mean recommended allocation to commercial property. The fall from 11% to 8% suggests the IFAs have responded quickly to the economic uncertainty affecting markets both domestically and outside the UK.

The frequency with which IFAs are recommending real estate has not changed significantly. Over 80% of respondents reported no change or a small increase in their propensity to recommend, so the qualities of the asset class remain popular but sentiment has moved away from the sector in that the level of the recommended allocation has fallen.

To underline this view, the number of IFAs that consider their clients to be over-invested in the asset class continues to exceed those that think their clients should increase their exposure to the asset class. The margin of difference has increased this time having fallen for the last three rounds of the survey.

These three factors suggest the strong capital inflows into the asset class seen in early 2010 particularly via retail funds may be slowing and may continue to shrink in the short term.

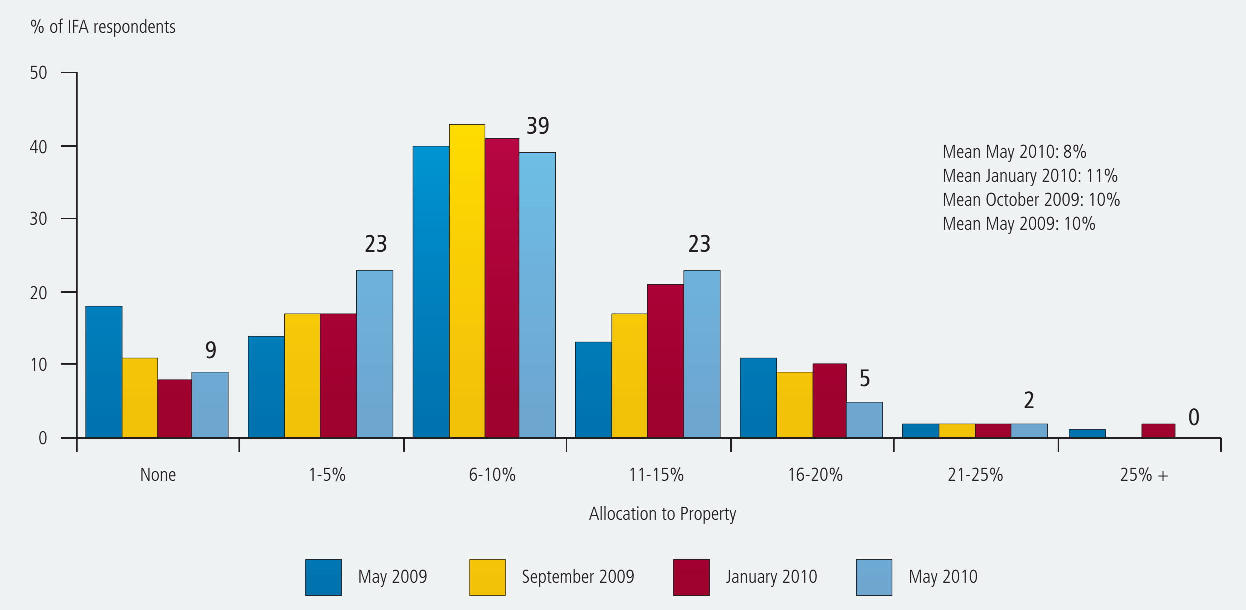
Interestingly, the reduced allocations are not being driven by an expectation of poorer performance amongst the IFAs. The expectations of short and long term returns for the asset class remain positive with the number of respondents expecting returns in excess of 6% over the next 12 months having increased in this round of the survey. However there remain some with very pessimistic views of the market; 18% of the respondents expect 12 month returns from the asset class to be zero or less. The mean expected return over 3 and 5 years are more positive at 6% and 8% respectively (see Figure 2).

Commercial property in the context of other assets

Evidence of increased risk aversion shows through again in the required returns reported by IFAs, from both commercial property and equities. The mean return in excess of the risk free rate required for commercial property investment has edged up slightly to 3.7%. The same measure for equities has also edged up but by more resulting in an increase in the margin between the two asset classes from 1.2% to 1.3%. The most frequently expected level of return expected from commercial property is still 2-3% in excess of risk free but its frequency has fallen slightly. The number of IFAs reporting required rates of return of 3-4% and 6-10% have increased.

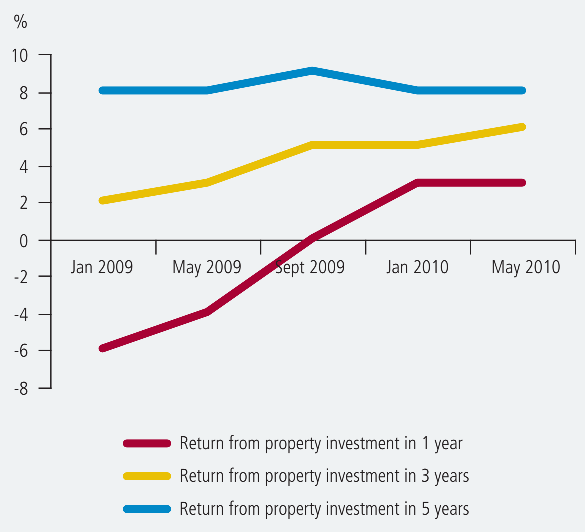
The important investment characteristics of commercial property for the IFAs have changed little; stable income return, capital growth and diversification qualities remain the key features. It is worth noting that low long term volatility, whilst routinely ranked fourth against these other features, is ranked 1st or 2nd by over 30% of respondents. This is another important characteristic of property as an asset class. Liquidity remains the least important characteristic in this list.

Figure 1: What percentage of a client's portfolio would you typically recommend being allocated to property investments?



Base: All Respondents: May 2009 (247), September 2009 (241), January 2010 (264), May 2010 (322)
Source: IPF Survey of IFAs June 2010

Figure 2: What are your expected average annual returns from property invstment over the following time periods?



Base: All Respondents: January 2009 (263), May 2009 (247), September 2009 (241), January 2010 (264), May 2010 (322)
Source: IPF Survey of IFAs June 2010

How and where are IFAs recommending their clients invest?

The vast majority of IFAs in the survey continue to recommend UK authorised unit trusts/property funds, pension funds and life funds as the most appropriate investment vehicles for their clients investing in commercial property. REITs and Investment Trusts vie for fourth and fifth position but their popularity with the IFAs remains a long way behind the more traditional vehicles. The IFAs preference for bricks and mortar funds invested in the UK or globally also remains.

This round of the survey shows a heightened level of uncertainty in respect of different geographical regions for investment. The data shows recommendations for all locations have fallen, with Europe seeing the sharpest fall, and the number responding 'don't know' to this question has increased. This uncertainty shows again in the questions relating to sector allocations. Some 47% of those surveyed responded 'don't know' when asked whether they thought there would be demand for specific sectors over the next six months. Healthcare and residential are the only two sectors where the number of respondents expecting an increase in demand has risen.

To summarise

This round of the survey shows the IFAs responding quickly to increased uncertainty in investment markets. The reduced level of recommended allocations to property, alongside an increase in the required rate of return for the asset class, show a heightened aversion to risk that might be expected during the political and economic uncertainty of the last few months, both domestically and outside the UK.

The continued recognition of commercial property as a mainstream asset class that is expected to produce stable income and capital growth whilst providing diversification benefits is an ongoing feature of this series of surveys. It suggests that whilst commercial property continues to conform to these characteristics demand from IFA clients will be sustained.

Notes:

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

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UK Consensus Forecasts May 2010

Louise Ellison, Research Director, IPF

The Q2 2010 IPF UK Consensus Forecasts show the All Property total return forecast for 2010 has been revised upwards but the dip in performance expected in 2011 has become more pronounced. This reflects downward revisions to capital value growth forecasts for all sectors except West End offices for 2011. However, disaggregating the forecasts by contributor type shows the figures for 2011 are not as clear cut as it might first appear. The fund managers' total return forecasts are more bearish than the property advisors and the range within their forecasts is wide. The consensus view shows a dip in performance is undoubtedly expected in 2011 but the extent of that dip remains open to debate.

The second point of note in this round of the survey is in the data for London City and West End offices. These two sub-sectors are now forecast relatively strong positive rental value growth in 2010, having been forecast as the sector laggards back in February. This strong rental value growth performance is expected to continue through 2011 and 2012 and to be supported by substantial capital value growth this year. These strong figures appear to be feeding through to the office sector forecasts, which again show stronger expected rental value growth than any of the other sectors for the three and five-year views. Rental value growth prospects remain weak at best for the other main sectors, with standard shops expected to fare the worst.

Outlook for property sectors

The rental value growth figures for the London City and West End office markets reflect the shortage of new space these markets are facing but must also be driven by an expected increase in demand for offices. The economic data goes some way to support this. The economic outlook remains weak with GDP falling back from 0.4% to 0.2% in Q1 2010. What growth there was, however, was driven partly by an increase in business

Figure 1: All Property rental value growth forecasts

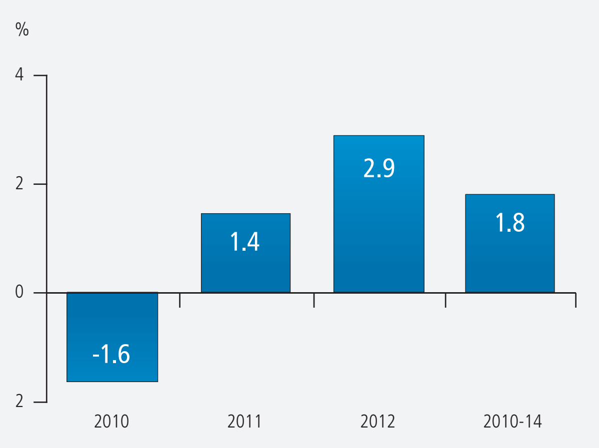


Figure 2: All Property total return forecasts

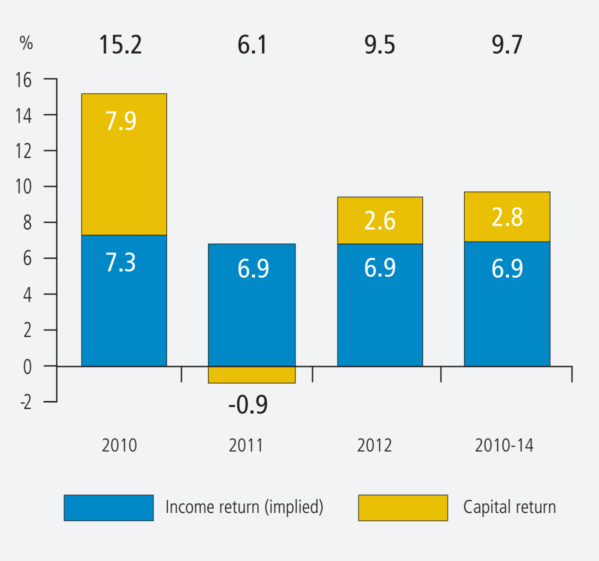


Figure 3: Survey results by sector

	Rental value growth %				Capital value growth %				Total return %			
	2010	2011	2012	2010-14	2010	2011	2012	2010-14	2010	2011	2012	2010-14
Office	0.7	4.1	5.1	3.5	9.6	0.7	4.0	3.6	17.0	7.5	10.8	10.5
Industrial	-2.3	0.0	1.5	0.7	5.5	-1.3	1.4	1.8	13.7	6.4	9.1	9.6
Standard shops	-3.1	-0.6	1.1	0.5	5.9	-2.4	1.1	1.7	12.5	3.8	7.4	8.0
Shopping centres	-2.5	0.2	1.8	1.2	7.2	-1.4	2.0	2.7	14.6	5.4	8.9	9.6
Retail warehouses	-1.6	0.7	2.4	1.6	8.2	-1.4	2.3	2.8	15.5	4.9	8.9	9.4
All Property	**-1.6**	**1.4**	**2.9**	**1.8**	**7.9**	**-0.9**	**2.6**	**2.8**	**15.3**	**6.0**	**9.5**	**9.8**
West End offices	3.4	6.9	7.9	5.8	13.9	2.6	7.2	5.5	20.4	8.3	12.7	11.3
City offices	4.9	7.1	7.3	5.5	15.7	2.5	5.8	4.9	22.8	8.8	12.0	11.4
Office (all)	0.7	4.1	5.1	3.5	9.6	0.7	4.0	3.6	17.0	7.5	10.8	10.5

services and finance output, particularly in banking and research and development. Provisional results show net business investment to have increased by 6% in Q1 2010 over the previous quarter, with construction seeing the biggest improvement.

The weakness in the retail sector forecasts is also underpinned by the economic data. The latest retail sales volume figures show an increase of just 1.8% on one year ago and an increase of 0.2% over the last three months. Sales volumes have fallen in predominantly food stores and risen in non-food retailing, particularly for textile, clothing and footwear.

The most recent CPI and RPI figures at 3.7% and 5.3% respectively suggest retailing volumes are going to remain weak as consumer spending power falls. This high level of inflation may be temporary and affected by increases in excise duties on alcohol and tobacco in April and by the low value of sterling. The latest labour market figures will also affect consumer spending. The number of people in employment has fallen to its lowest level since 1992 and the number unable to find full time employment, so working part-time, rose to its highest level yet at 1.07m. Unemployment rose again to 2.51m and the number of vacancies fell.

Interestingly total earnings growth is higher this quarter at 4% largely due to an increase in bonus payments on 12 months ago. With bonuses stripped out the figure falls to 1.9%, substantially below both CPI and RPI.

Key points

The IPF UK Consensus Forecast all property total return forecast for 2010 has improved again this quarter, rising to 15.3%. The prognosis remains for a sharp improvement in performance in 2010 followed by a dip in 2011 and recovery in 2012.

- The Q2 2010 Consensus Forecast consolidates the upwards revisions seen over the last three quarters. The more recent forecasts again are more positive but the trend is less pronounced than in Q1.
- The total return forecast for 2011 has again been moderated downwards this time from 6.6% to 6.0%. The shift is marginal but underlines the expectation of a dip in performance next year.
- The forecast total return for 2012 is again marginally up on Q1 rising from 9.1% to 9.5%. The five-year view is marginally lower.
- The improved forecasts for 2010 are driven by higher forecast rental and capital value growth. Whilst rental value growth remains negative it has moved up from -4.4% to -1.6% this quarter. The shifts in the capital value growth forecasts are much more significant, up from 5.9% to 7.9% for 2010.

City and West End office subsector forecasts have been revised substantially to show a stronger outlook for both rental and capital value growth

- Across the sectors the most significant changes are in the West End and City office subsector forecasts. Both sectors are now forecast total returns in excess of 20% for 2010. The forecasts for 2011 and 2012 are more conservative, with City offices having been revised marginally downwards, but the two sectors remain expected to be the strongest performers over the three and five-year views.
- The improvement in the City and West End office total return forecast for 2010 is driven by strong improvements in both rental value and capital value growth forecasts. Both sectors are now forecast the strongest rental and capital value growth of all the sectors for 2010, a major revision in outlook since Q1.
- Across all sectors performance is forecast to be weak in 2011 with capital value growth forecasts lower this quarter than in Q1. Standard shops are the laggards.
- 2012 remains forecast to be a year of more stable growth but again rental and capital value growth forecasts for standard shops have been revised downwards.
- The five-year total return forecasts have moved only marginally with shopping centres and standard shops moving down slightly. All sectors are forecast to provide above inflation returns over the five year view.

Figure 4: Property advisors and research consultancies (11 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Maximum	0.8 (1.2)	3.2 (5.5)	5.1 (6.9)	9.8 (9.8)	4.2 (8.8)	7.6 (6.6)	18.4 (18.6)	11.4 (16.0)	15.3 (14.0)
Minimum	-3.0 (-7.7)	0.0 (-1.2)	1.6 (0.7)	6.3 (-1.7)	-2.1 (-3.3)	-0.5 (-1.0)	13.6 (5.7)	5.0 (3.9)	7.0 (6.0)
Range	3.8 (8.9)	3.2 (6.7)	3.5 (6.2)	3.5 (11.5)	6.3 (12.1)	8.1 (7.6)	4.8 (12.9)	6.4 (12.1)	8.3 (8.0)
Median	-1.3 (-3.7)	1.5 (0.5)	3.0 (2.9)	8.4 (6.8)	0.1 (0.8)	2.6 (1.4)	15.7 (14.6)	7.5 (8.1)	9.2 (9.1)
Mean	-0.9 (-3.4)	1.5 (0.5)	3.1 (2.7)	8.2 (5.7)	0.9 (1.2)	2.9 (2.0)	15.8 (13.5)	7.9 (8.5)	9.9 (9.1)

Figure 5: Fund managers (15 contributors)									
	Rental value growth %			Capital value growth %			Total return %		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Maximum	0.1 (-0.4)	4.4 (4.6)	3.8 (4.2)	12.0 (14.3)	2.7 (2.7)	4.9 (5.3)	19.5 (21.4)	9.7 (9.3)	11.9 (11.7)
Minimum	-6.9 (-12.0)	-1.3 (-3.6)	1.1 (-1.0)	3.3 (-0.1)	-10.9 (-8.1)	-2.7 (-1.8)	10.7 (7.2)	-3.5 (-0.7)	4.7 (4.8)
Range	7.0 (11.6)	5.7 (8.2)	2.7 (5.2)	8.7 (14.4)	13.6 (10.8)	7.6 (7.1)	8.8 (14.2)	13.2 (10.0)	7.2 (6.9)
Median	-1.9 (-3.8)	1.7 (-0.2)	3.0 (2.4)	7.7 (5.9)	-1.7 (-2.3)	3.1 (2.6)	15.2 (13.2)	4.2 (4.7)	9.0 (8.5)
Mean	-2.2 (-5.3)	1.4 (-0.2)	2.7 (2.1)	5.9 (2.8)	-2.1 (1.0)	2.3 na	14.9 (13.1)	4.4 (5.0)	9.1 (8.8)

Figure 6: All forecasters (26 contributors)									
	Rental value growth %			Capital value growth %			Total return %		
	2009	2010	2011	2009	2010	2011	2009	2010	2011
Maximum	0.8 (1.2)	4.4 (5.5)	5.1 (6.9)	12.0 (14.3)	4.2 (8.8)	7.6 (6.6)	19.5 (21.4)	11.4 (16.0)	15.3 (14.0)
Minimum	-6.9 (-12.0)	-1.3 (-3.6)	1.1 (-1.0)	3.3 (-1.7)	-10.9 (-8.1)	-2.7 (-1.8)	10.7 (5.7)	-3.5 (-0.7)	4.7 (4.8)
Range	7.7 (13.2)	5.7 (9.1)	4.0 (7.9)	8.7 (16.0)	15.1 (16.9)	10.3 (8.4)	8.8 (15.7)	14.9 (16.7)	10.6 (9.2)
Std. Dev.	1.5 (2.9)	1.2 (2.0)	1.0 (1.6)	1.9 (3.3)	3.4 (3.6)	2.3 (2.6)	2.1 (3.4)	3.6 (3.5)	2.3 (2.5)
Median	-1.7 (-3.7)	1.6 (0.2)	3.0 (2.6)	8.2 (6.8)	-0.8 (0.2)	2.6 (2.4)	15.5 (14.4)	6.1 (7.8)	9.2 (9.2)
Mean	-1.6 (-4.4)	1.4 (0.1)	2.9 (2.4)	7.9 (5.9)	-0.9 (-0.6)	2.6 (2.3)	15.3 (13.4)	6.0 (6.6)	9.5 (9.1)

Notes

1. Figures are subject to rounding, and are forecasts of All Property or relevant segment Annual Index measures published by the Investment Property Databank. These measures relate to standing investments only, meaning that the effects of transaction activity, developments and certain active management initiatives are specifically excluded. **2.** To qualify, all forecasts were produced no more than two 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.

The 26 contributors to this quarter's forecasts at the All Property level include 11 property advisors and 15 fund managers. There were no equity broker forecasts that could be included in this round of the survey. Of the 26, 23 contributors provided sector forecasts and 21 provided West End and City office segment forecasts. All forecasts were produced within the last 12 weeks.

Acknowledgements

The Investment Property Forum would like to thank the following organisations for contributing to the IPF UK Consensus Forecasts for Q2 2010:

Property advisors (includes research consultancies): BNP Paribas Real Estate, Capital Economics, CBRE, Cushman and Wakefield, Fletcher King, GVA Grimley, Jones Lang Lasalle, King Sturge, Paul Mitchell Real Estate Consultancy, Real Estate Forecasting Limited, Strutt and Parker.

Fund managers: Aberdeen Property Investors, Aviva Investors, Axa Real Estate Investment Management, CBRE Investors, F&C REIT Asset Management, HSBC Real Estate Multimanager, ING, Invista REIM, LaSalle Investment Management, Legal and General Investment Management, PRUPIM, RREEF Alternative Investments, Schroders, Standard Life, SWIP.

European Consensus Forecasts
May 2010

Louise Ellison, Research Director, Investment Property Forum

Key Points

- Forecasts continue to improve overall but few cities are expected to show positive rental value growth in 2010.
- London City and West End markets are forecast the strongest rental value growth for the full three year and five year figures reported.
- Warsaw and Paris are also expected to show positive rental value growth in 2010 but all other cities are forecast further rental value growth falls for this year.
- A clear gap has emerged in the 2010 figures between the forecasts for Barcelona, Madrid and Dublin, where rental values are expected to continue to fall sharply through 2010, and the other European cities reported.
- Figures for 2011 show some recovery is expected in rental value growth but this is expected to be slow in the majority of European city office markets.
- The first figures for 2012 show positive rental value growth is expected in all centres covered.

Forecasts for 2010 show strong rental value growth expected in London

The first round of the IPF European Consensus Forecast for 2010 shows a strengthening outlook for London's City and West End office markets. Having been forecast to experience the strongest rental value growth of the centres reported in the November 2009 survey, the figures have again been revised upwards, sharply. The consensus rental value growth forecast for City of London offices has moved from 0% to 12.8% in this round of the survey and for London West End from -2.2% to 7.8%. These figures may well reflect concerns regarding restrictions in the supply of new prime office space in London in the medium term.

Expectations for Warsaw have also improved sharply, perhaps reflecting Poland's relatively robust economic performance through the recession. Warsaw is ranked fourth in terms of expectations of rental value growth for 2010 compared with a ranking of 26 in the November 2009 forecasts. The consensus for rental value growth for 2010 moved from -6% in November 2009 to 1.6% in this round of the survey. Paris CBD is the only other centre forecast positive rental value growth for 2010.

At the other end of the table the forecasts for those cities currently most affected by economic distress and uncertainty, unsurprisingly remain very weak. Rental value growth expectations have worsened in Madrid which is now forecast marginally weaker rental value growth than Barcelona at -10.8% and -9.2% respectively. Forecasts for Dublin also remain very weak and a clear gap can be seen in the forecast rental value growth figures of these cities and the other European centres covered.

Outlook for 2011 marginally improved but recovery expected to be weak

The forecasts for 2011 have changed markedly in this round of the survey. The consensus forecasts of prime office rental value growth in the City of London and London West again expect these centres to see much sharper rental value growth than all other centres reported, at 8.7% and 8% respectively.

Just six of the 29 cities reported are forecast negative rental value growth in 2011. This is an improvement on the last consensus figures reflecting a marginally stronger economic outlook across Europe, however the figures do not suggest any marked recovery in rental value growth is expected anywhere other than London. The consensus forecasts for both Berlin and Frankfurt have been revised downwards and just 12 of the 29 cities are forecast rental value growth in excess of 1%. The remainder are grouped between 0% and 1% suggesting rental value growth with be little more than flat. There is little sign of a recovery of the falls in rental levels experience over the last two to three years.

Figures for 2012 and the three- and five-year forecasts

The first figures for 2012 show the consensus is for rental value growth in the two London centres to remain ahead of all other centres. The consensus forecasts for rental value growth are positive for all cities by 2012 although the figures remain relatively weak. This weakness is further reflected in the three-year forecasts where the consensus is for nine of the 29 centres to experience negative rental value growth over the three-year period from 2010 to 2012 (see Figure 1). The five-year forecasts are more positive with just Athens forecast negative rental value growth over the five years to 2014. Nonetheless, with the exception of the two London centres, rental value growth is expected to remain weak across the European centres for some time to come.

Summary

The May 2010 IPF European Consensus Forecast builds on the more positive outlook reflected in the November 2009 survey. The figures for London are the most striking with strong rental value growth now forecast for prime offices in the City and West End of London for the next five years. However recovery in rental value growth in the vast majority of European cities remains weak suggesting little expectation of any recovery in occupier demand. The depth of the economic difficulties facing Spain and Ireland in particular show in the forecasts with key cities in these countries expected to continue to suffer falling rental values for the next two years.

Figure 1: European office market prime rent forecasts, May 2010

	Year rental growth forecast % pa 2010	2011	2012	3-year forecast 2010-12 % pa	5-year forecast 2010-14 % pa
Vienna	-3.1	0.5	2.6	0.0	1.5
Brussels	-1.7	1.0	2.5	0.6	2.4
Prague	-5.4	1.0	3.0	-0.5	1.4
Copenhagen	-1.3	0.2	1.9	0.2	1.1
Helsinki	-1.5	1.0	3.2	0.9	1.4
Lyon	-3.4	-0.1	3.0	-0.2	1.6
Paris CBD	1.8	3.3	6.1	3.7	4.1
Paris la Defense	-1.2	2.0	4.5	1.7	3.6
Berlin	-0.8	1.2	2.5	1.0	1.5
Frankfurt	-1.4	-0.1	3.6	0.7	1.9
Hamburg	-3.1	0.7	3.0	0.1	1.3
Munich	-1.3	0.4	2.7	0.6	2.0
Athens	-4.8	-1.8	1.9	-1.6	-4.7
Budapest	-4.4	0.0	1.7	-0.9	2.3
Dublin	-9.0	-0.9	3.2	-2.4	1.3
Milan	-4.0	1.1	3.9	0.3	2.8
Rome	-3.0	0.5	2.0	-0.2	2.2
Luxembourg	-2.1	1.0	2.4	0.4	2.1
Amsterdam	-1.9	1.1	2.5	0.6	2.1
Oslo	-2.7	2.4	4.5	1.4	4.0
Warsaw	1.6	3.2	4.2	3.0	2.7
Lisbon	-4.7	0.2	1.4	-1.1	0.3
Moscow	-4.8	3.7	8.3	2.2	4.4
Madrid	-10.8	-2.1	2.8	-3.5	1.6
Barcelona	-9.2	-2.4	1.4	-3.5	0.6
Stockholm	-2.3	2.9	4.6	1.7	3.6
Zurich	-3.9	1.8	3.5	0.4	2.1
London:City	12.8	8.7	9.6	10.4	7.6
London: West End	7.8	8.0	8.6	8.1	7.0
Manchester	-3.1	0.7	2.6	0.0	1.3

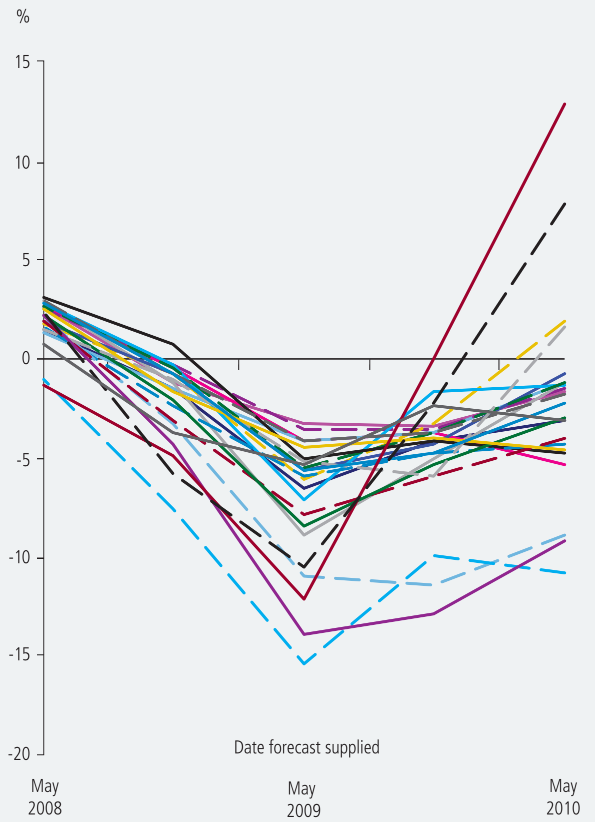
Forecast Contributors: IPF would like to thank the following organizations for contributing data to the May 2010 European Consensus Forecasts: Aberdeen Property Investors, Alecta, Aviva Fund Management, Cushman & Wakefield, DTZ, Grosvenor, Invesco, PMRECON, PPR, Schroders, Standard Life Investments, SWIP.

Notes

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

In addition to the rental value forecasts, we run a consensus survey of forecast IPD European total returns by sector. The samples provided for this survey were once again small, and not sufficient to permit publication. We

Figure 2: Forecasts for year 2010



Key for Figures 2-3

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

Key for Figure 4

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

Figure 3: Forecasts for year 2011

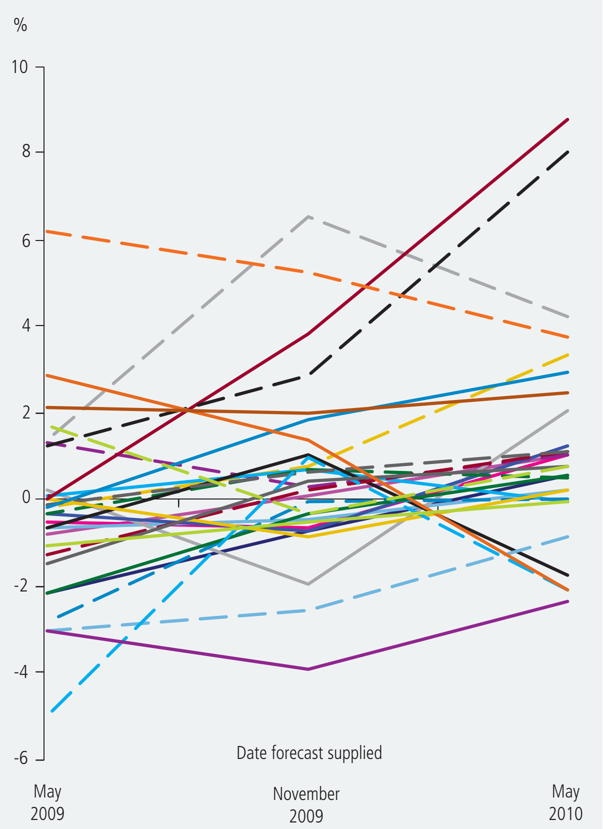
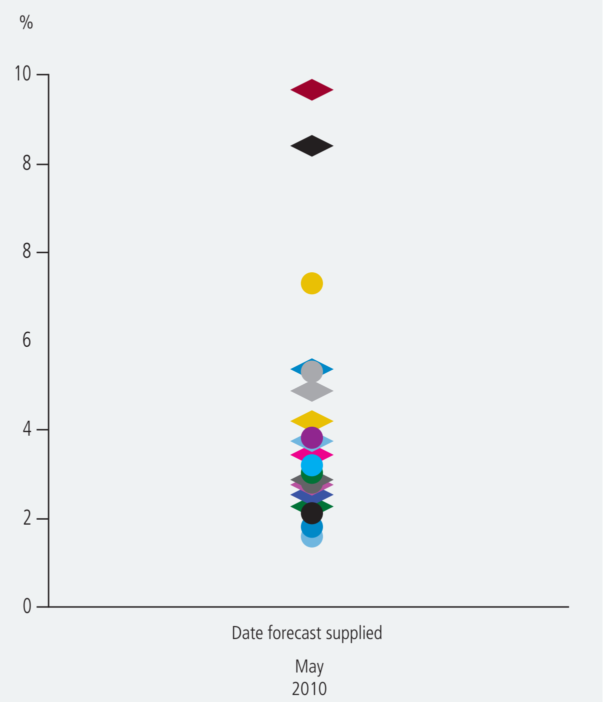


Figure 4: Forecasts for year 2012



hope to be able to produce a full release of this data at some time in the future, once the number of responses has grown sufficiently.

The Data

This latest survey collected prime office rental forecasts for 29 centres for the calendar years 2010, 2011 and 2012. We request a three-year average forecast for 2010-2012 if individual years are not available, and a five-year average for 2010-14. The survey requested both the percentage annual rental growth rates and also year-end rent levels. The growth forecasts provided by each organisation have been analysed to provide average ('consensus') figures for each market.

The definition of market rent used in the survey is 'achievable prime rental values for city centre offices, based on buildings of representative size with representative lease terms for modern structures in the best location.' Prime in this case does not mean headline rents taken from individual buildings, but rather rental levels based on market evidence, which can be replicated. All figures included in the survey are required to have been generated by formal forecasting models. The report is based on contributions from 15 different organisations.

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

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

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

Disclaimer

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Forum activities and announcements

Executive team

It is with regret that we say goodby to Pat Johnson who left us at the end of June after 10 years at the IPF. We wish her a very happy retirement.

Cheryl Collins has joined the IPF to take over Pat's role as Membership Co-ordinator. Her email address is ccollins@ipf.org.uk

Frankie Clay has been promoted to Associate Director – Education, with effect from 1 July.


Midlands Annual Lunch

7th Annual Property Investment Conference in Scotland

Entitled 'Property Investment: A New Landscape', the 7th Annual Property Investment Conference was held on 9 June at Scottish Widows' Headquarters in Edinburgh. This event was attended by nearly 100 delegates and a full report on the Conference can be found on pages 14-15.


Max Sinclair, new Management Board member, addresses the Conference

Networking at the conference.

We are grateful to Miller Developments and SWIP for their support of the Conference.

Midlands Annual Lunch 2010

Nearly 200 guests attended the Midlands Annual Lunch on 7 May 2010. Following the lunch, David Allen talked to Ian Marcus in a Q&A session, a format that proved to be very popular and well received.


Midlands Annual Lunch: Ian Marcus, Adrian Watson & Peter Pereira Gray

Annual Dinner 2010 (photos opposite)

925 guests attended the IPF Annual Dinner held at the Grosvenor House on 23 June. The event was kindly sponsored by Knight Frank, Langham Hall and VALAD Property Group. Rory Bremner entertained guests after dinner with an amazing array of impersonations on topical subjects ranging from the World Cup to the Coalition Government.

John Gellatly, Chairman, IPF, addressing members and guests

Scottish Board

Paul Findlay, SWIP

Following his rewarding year as Chairman of the Scottish Board, Graham Sanders of Sanders Cartwright has ceded his Chairmanship to **Paul Findlay** of Scottish Widows Investment Partnership. We would like to thank Graham for his time leading the IPF in Scotland.

Midlands Board

Adrian Watson of Cobbetts LLP will be stepping down as Chairman of the Midlands Board in September, following a fruitful two years in the role. **Simon Robinson** of GBR Phoenix Beard is his able successor.

The Great Room, Grosvenor House

Adrian Watson & Simon Robinson

IPF National Board

Three members of the IPF Management Board stepped down at the AGM on 17 June – Fiona Morton, Mark Titcomb and Ian Womack. Peter Pereira Gray, as outgoing Chairman, acknowledged the huge contribution all three have made to the IPF during their time on the Board.

The Management Board will be bolstered by three new additions; **Chris Ireland** of King Sturge, **Max Sinclair** from Eurohypo and **Andrew Smith** of Aberdeen Asset Managers.

Rory Bremner entertains guests

Investment Education Programme (IEP)

The final module in the current IEP cycle, Portfolio Management will be taking place on 7-9 September. If you would like more details on this course, please visit the IPF website, or call **Frankie Clay**, Associate Director – Education, 020 7194 7928.

The 2010-2011 cycle will begin with Introduction to Investment Valuation and Portfolio Theory in late September 2010.

Investment Education Programme timetable 2010-11
Investment Valuation and Portfolio Theory
27-29 September 2010
Financial Instruments and Investment Markets
22-24 November 2010
Property Investment Appraisal
17-19 January 2011
Property Finance and Funding
1-3 March 2011
Indirect Property Investment
5-7 April 2011
International Property Investment
6-8 June 2011
Portfolio Management
6-8 September 2011

IPF Research Programme extended to March 2011

We would like to thank all our existing sponsors for the invaluable financial and practical support they continue to give to the IPF Research Programme. We also like to thank those who have agreed to provide additional finance through 2010 to enable the programme to be extended to March 2011 and the IPF Education Trust for making an additional grant to the IPF Research Programme in support of this continuation.

Over the next six months we will be raising finance for the next Research Programme which will run from April 2011 for four years. If your organisation would be interested in the sponsorship arrangements for this new IPF Research Programme please contact **Louise Ellison** lellison@ipf.org.uk 020 7194 7925 for more information.

Future events for your diary

Midlands Annual Dinner
14 October 2010, ICC, Birmingham
Guest Speaker: Gerald Ratner

Kindly sponsored by:
Abstract Land
Lloyds TSB Corporate Markets
Lockton – Insurance & Risk Management Specialists
and Nottingham Trent University

Annual Lunch
28 January 2011, Hilton Park Lane, London

Should you be interested in sponsoring this event, please contact **Sue Forster**, email: sforster@ipf.org.uk

The IPF Research Programme has developed as an important provider of high quality independent research focused specifically on property investment. We can only continue to fulfil this role due to the support of our 24 research sponsors. We are very grateful to this group of companies for their support of the programme.

Addleshaw Goddard

Aviva Investors

British Land

Credit Suisse

Deloitte.

DLA Piper

DTZ

GIC Real Estate

Grosvenor

GVA Grimley

Hammerson

Helical Bar plc

IPD

Kenmore property group

Knight Frank

LandSecurities

LaSalle Investment Management

Legal & General

Nabarro Clarity Matters

PRUPIM

Quintain

Standard Life Investments

Strutt & Parker

Scottish Widows Investment Partnership

IPF Investment Property Forum

10 YEARS OF IPF MIDLANDS 2000-2010

Midlands Annual Dinner 2010

Thursday 14 October
18:30 for 19:30 • Black Tie

Ticket price: £89 + VAT
(excluding wine and liqueurs)

Join us to celebrate the IPF Midlands Region's 10th Anniversary

IPF members may reserve tables for the dinner by completing a booking form and returning it with payment as soon as possible. Tables will be for 10 – all business associates and colleagues are welcome. Individual bookings can also be made and, in this case, please indicate if you wish to join a table with specific people.

Please note that wine orders, hosted bars and special dietary requirements must be arranged directly with the International Convention Centre (ICC).

For more information or to book, contact Joanna Puckett on 020 7227 3456 or email Joanna on ipfdinner@secretariat.org.uk

Venue:
International Convention Centre, Broad Street, Birmingham B1

Guest Speaker: Gerald Ratner

Gerald Ratner transformed his family jewellery chain of 130 stores with sales of £13m to a public company with 2,500 stores and sales of over £1.2bn. By 1990, Ratner's was the world's largest jewellery retailer with profits in excess of £120m.

Following a widely reported gaffe in which he compared his products to M&S prawn sandwiches, Gerald was forced to sell the business. Reduced to virtually nothing and shunned by banks and prospective employers, he eventually picked himself up and clawed his way back – first with a health club then with geraldonline. The Internet jewellery business is now the largest in the sector.

After turning around his fortunes, Gerald talks with typical candour and a great deal of humour about the rollercoaster journey.