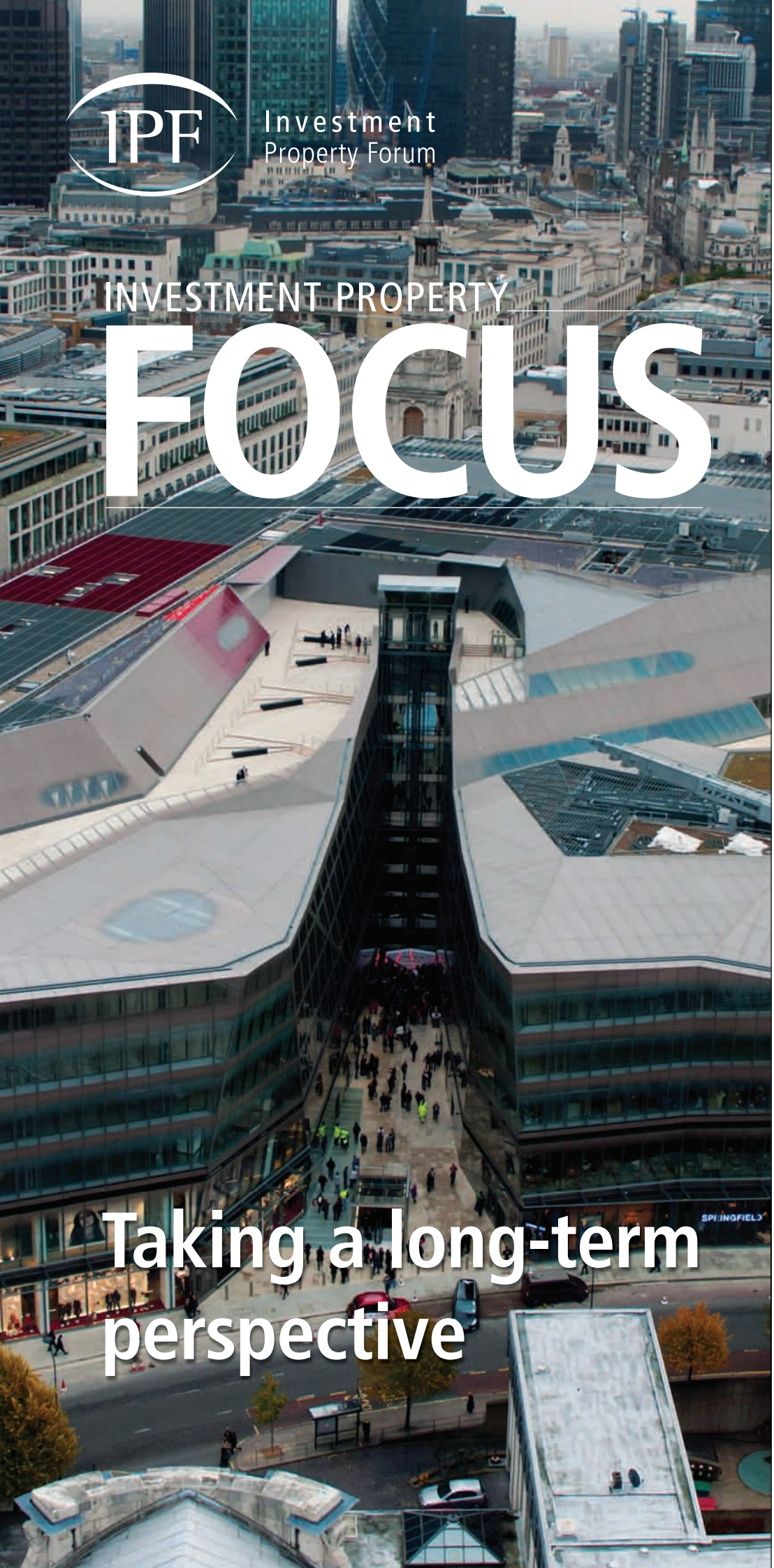

Investment Property Forum

INVESTMENT PROPERTY

FOCUS

Taking a long-term perspective

The Journal of the Investment Property Forum
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In this issue:

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.

From the editor

Sue Forster, Executive Director, IPF

This edition of Investment Property Focus balances the retrospective with new developments. **Louise Ellison**, the IPF Research Director, provides an example of the latter with an outline of the new Sustainable Property Investment Index, launched by IPD and sponsored by K & L Gates and the IPF. The original research for the index was funded by the IPF Research Programme and published in October 2009. A lot more properties are required before the index can tell us anything about the performance of sustainable property but at least the framework for measurement is now in place.

Following a very successful IPD/IPF conference in Brighton at the end of November, we asked **Robert Houston** of St Bride's Strategic Advisors to reprise his conference chairman's address – not least so we could get the picture of Duck à l'Orange in print. He calls for a major re-evaluation of what really matters to our property industry, with less focus on short-term objectives and greater emphasis on long-term strategy.

Neil Blake of Oxford Economics, **Angus McIntosh** of King Sturge and **Chris Simmons** of Real Estate Forecasting take a fresh look at the question as to whether property is a hedge against inflation. Their research, funded by the IPF Research Programme, concludes that in most cases it is not. However, property does hedge against economic growth and delivers long-term real returns. They also look at the total returns for property and other asset classes in different inflationary and economic growth regimes and the performance of the individual property sectors in periods of high and low inflation.

Another major project funded by the IPF Research Programme this year looked at the causes of portfolio risk. **Gerald Blundell**, together with **Malcolm Frodsham** and **Roberto Martinez Diaz** of IPD, identified nine structural factors and three cyclical factors that were key to explaining the residual differences in performance between a portfolio and the market.

Andrew Bell argues for the need to apply more risk management analysis to transactions, particularly given increased volatility in the market and the abandonment of long-term buy-and-hold strategies for property. He looks at what additional finance modelling techniques can do to enhance corporate decision making.

This year's Property Industry Alliance and Corenet Global Occupier Satisfaction Survey saw a change in format, being a more detailed questionnaire based on the Lease Code. **Stuart Morley** of GVA Grimley, who undertook the survey, outlines the findings. These suggest that overall occupiers feel that UK landlords provide a moderate level of service, with definite room for improvement.

The Q4 2010 IPF UK Consensus Forecast shows that expectations for both capital and rental growth have improved marginally across the sectors, although rental value growth remains negative other than for offices. The more gloomy forecast for 2011 reflects anticipated weak economic growth coupled with an upward pressure on inflation. There would seem to be light at the end of the tunnel for property in 2012.

The picture in the European Consensus Forecast mirrors that of the UK forecast, but also included in this section is the European transaction data produced by Real Capital Analytics.

The Midlands 10th anniversary Dinner, highlighted in Forum Activities and Announcements provides an upbeat note upon which to end this edition. Let's hope our Annual Lunch on 26 January 2011 continues along this vein.

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Moving sustainable property investment forward

The Sustainable Property Investment Index has arrived

Louise Ellison, Research Director, Investment Property Forum

On 12 November 2010, the property industry gained a new tool to help us begin to understand how sustainability might affect the investment performance of investment assets. The Sustainable Property Investment Index, launched by IPD and sponsored by K & L Gates and the IPF, provides a means of determining at a basic level the sustainability of existing assets in property investment portfolios and monitoring the investment performance of a subset of more sustainable assets.

The determination of which assets form the more sustainable subset is based on a simple set of metrics (see box below) developed through research funded by the IPF Research Programme and published in October 2009[1]. IPD has used these metrics to analyse some 978 properties within 90 portfolios from 24 different fund managers.

This strong engagement from fund managers is encouraging but it is worth noting at that the provision of this fairly basic data was a painful process and none of the fund managers could provide data on a complete portfolio. As an industry we still have a long way to go in terms of collating even basic sustainability data on our buildings.

The significance of this development is not in the performance number it produces. The significance is in the availability of a simple, industry recognised measurement system that will allow fund managers to better understand the extent to which their assets conform to a common standard. As time progresses, the sample size increases and the market begins to price sustainability into rents and capital values, we may be able to identify common sustainability features in assets whose investment performance is different from others in their asset class.

This is a starting point, not an end point and must be seen as such. We would urge fund managers who are yet to participate in this project to contact IPD with a view to submitting data on as many assets as possible. We would further urge those who are participating to work on increasing the number of assets within each portfolio for which they can contribute data. Those who are participating also need to use the outputs within their asset management processes; 7% is a very small proportion of assets to qualify as sustainable and one as an industry we surely need to improve.

Figure 1: Index criteria

QUALITY	Pass if BREEAM rated Very Good or above
ACCESSIBILITY	Pass if 5 minutes' walk max) to nearest public transport node OR cycling storage + cycling facilities + green travel plans
ENERGY	Pass if EPC is A-C OR >5% renewable energy + EPC is A-E OR naturally ventilated + EPC is A-E OR built later than 2005 + EPC is A-E
FLOODING	Pass if not in a flooding area OR if flooding risk is low + flooding defences in place
WASTE	Pass if waste recycling occurs
WATER	Pass if water recycling in place OR water efficient fittings in place + water metering in place.

Of the 978 properties assessed, 69 or 7% were judged to be 'more sustainable' and these formed the sub-sample for performance tracking. This is perhaps one of the most revealing statistics of the exercise. Even on the relatively basic metrics applied, the vast majority of existing stock does not measure up in terms of sustainability.

These 69 properties form a tiny sample of properties within which investment performance will be determined by a range of factors completely unrelated to their sustainability. Given that sustainability has not been priced into rental or capital values thus far there can be no rationale for expecting the performance of this subset, be it good or bad, to be related to their sustainability credentials.

Getting this far has been a major challenge. Now we have reached this point we have a system in place that can help us move forward, hopefully more efficiently and more quickly. But please do not look for the Sustainable Property Investment Index to say anything useful about the performance of sustainable assets yet – 69 assets can tell us a lot, but not that.

1 See IPF 2009 ISPI (UK) The development of a sustainability property investment index, IPF: London

Reflections

Robert Houston, Principal, St Bride's Strategic Advisors

Robert Houston chaired the 20th IPD/IPF Property Investment Conference, held in Brighton at the end of last month. As he was also a speaker at the very first conference, he is ideally placed to reflect on where the UK property market is currently and where it might be heading.

When I was asked to speak at the very first IPD conference in 1990, at Hanbury Manor, I had no idea what to expect from either my fellow speakers, the delegates, or the overall event itself. So, I rocked up with one of my normal light-hearted talks... this time based around Scrabble, the board game. My heart sank. All the other speakers had spoken solemnly, wisely and intensely and it looked as if I was just larking around. That said, I am pretty sure that I had a serious message embedded somewhere in my content. You can imagine – it was a bit like turning up to a black-tie dinner wearing a tracksuit!

It was pretty obvious that IPD would never ask me to speak again. And yet somehow, someone, somewhere, must have put in a good word for me as I have made various appearances since. And this year, I received the ultimate accolade... they asked me to be the Conference Chairman.

Well, of course, being the event's 20th anniversary – which undoubtedly has been strengthened in more recent years by the support of the IPF – the Scrabble letters just had to be given a fresh airing!

So, using 14 'random' letters, here are some of my reflections on how things are today. The letters make up a 3 word anagram:

M$_3$	N$_1$	L$_1$	O$_1$	N$_1$
E$_1$	T$_1$	O$_3$	I$_1$	V$_4$
S$_1$	I$_1$	R$_1$	G$_2$	

M$_3$ **is for Mood**. The mood of the country, and the property sector in particular, is seriously down-beat. That's hardly surprising given the trauma of the last three years and the still unknown human consequences of the Government's austerity measures.

N$_1$ **is for Negativity**. The trouble is that constant negativity will only compound the problem. Sadly, too many people cannot see a way out of their financial and social maze. It's no good bursting into tears. You just have to find the right way out. And if you hit a dead end first off, then try another route.

L$_1$ **is for Lost Souls**. There is a generation of youngsters who joined the property industry in the noughties whose expectations have been exclusively 'upward only' – career, remuneration, social life... The abruptness of the turn-around in the last three years has left them bemused, even angry, and certainly searching for a new direction. You might say that that is their problem, but, the property industry can ill-afford to lose another generation of talented youngsters as we did in the last major down-turn of the 1990s.

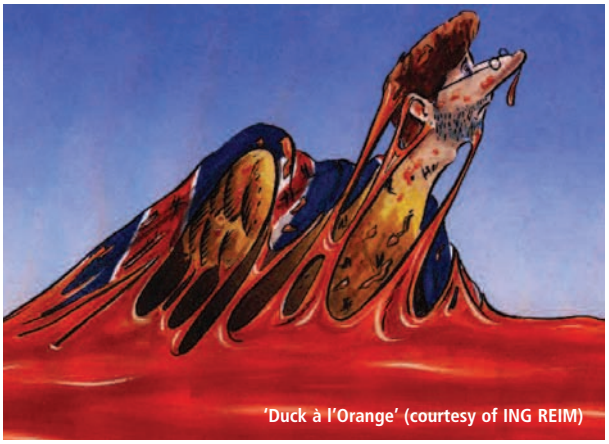
O$_1$ **is for Opportunity and Optimism**. I urge this new generation to dig deep. Remember, if everyone else's eyes are looking down, they won't be able to see the opportunity when it arises. I am not advocating recklessness. I am not saying it will be easy. I am suggesting that you need to keep a sense of optimism and boldness.

N$_1$ **is for New spirit**. In short... I am urging a new spirit of ideas, innovation, entrepreneurship and sheer hard work. We will all get through it, then.

E$_1$ **is for the Economy**, which will (at best) bumble along. My fear is that the economic divide that has appeared between London and the rest of the UK will get even wider. London undoubtedly is a great city; a truly global centre, but what is going to put the spark back into the regions? I don't know... and it worries me.

T$_1$ **is for Ten years**. I first went public in November 2007 on my 'doomsday' prediction for recovery. I said then that it would take a full 10 years, i.e. until 2017. Regrettably, I still stand by that time frame. Sorry! There are so many pot-holes and bits of debris to manoeuvre around – not least the still enormous unpaid mountain of debt – that anything sooner is wishful thinking.

O$_1$ **is for à l'Orange**. Back in 1992, in the old Baring, Houston & Saunders days, we described the property market then as being 'all gunged up'. In line with our Duck Dive series of market

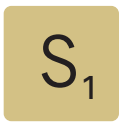


'Duck à l'Orange' (courtesy of ING REIM)

movements, it was like 'Duck à l'Orange'! The sector wanted to regain its composure... but too many sticky forces were holding it back. That's almost exactly how things are today.

is for Initial Yields. Over the past 10 years, the sector seems to have been fixated by trying to guess the size and direction of the next market yield movement. Will it go up? Will it go down? But it is just that... a guess. The current consensus is that yields will soften over the coming months. But I could easily come up with a perfectly cogent case for why they might do exactly the opposite i.e. harden, especially given the yield gap / risk premium that currently exists between property and equities, bonds and cash.

is for Value. The consequences of renewed yield compression, of course, would be higher capital values. Maybe. But I suspect that investors / lenders still haven't yet properly recognised the true market / sale value of certain type of assets they own yet anyway... especially those properties which are vacant or are at risk of vacancies.



is for Strategic thinking. This is my greatest concern. Too often business and investment decisions are being made with only short-term objectives in mind.

is for Instant gratification. Investors (or their managers anyway) seem to want instant success. It's bonkers. Lasting success can only be achieved through sheer graft. Please, please, please can we get back to the real world. Property needs a long-term perspective.

is for Retention. Every business consultant under the sun will tell you that a company's priority should always be to retain its existing clients. Losing clients and then having to replace them is not only debilitating, it's very very expensive. And, it is exactly the same for retaining tenants. Never has it been more true that 'a bird in the hand is worth two in the bush' than now. The time, energy and ingenuity required by landlords to deal with cost conscious tenants will have to increase significantly. No. I mean massively!

is for Global. I love the UK. I wouldn't want to live anywhere else. I love our sense of fairness and I love our sense of humour and self-deprecation. But, I am afraid we are rapidly losing our influence on the global stage. And our property industry is not immune to this either. Consider:

- Our large firms of chartered surveyors effectively invented modern property investment management, back in the 1970s. However, virtually all of these firms have now been bought by US or other overseas players.
- The UK was consistently the number one destination for overseas property investors. They just loved our long leases and eccentric upward only rent reviews. We all know however that such investment security now has all but gone.
- The rigour of the RICS valuation code, the IPD Index and the overall transparency of the UK sector was unparalleled elsewhere. But such has been the success of IPD and others that lots of other countries have caught up with us.
- London remains a global beacon, but it is under severe competition from the likes of New York, Hong Kong and Tokyo. Nothing should be taken for granted.
- The UK pension fund consultants have been won over by the case for overseas investment and in turn they are steadily winning over their institutional clients. The door, for a significant push towards global strategies, is wide open. But how well are we, in the UK, positioned to deal with this? Probably only so-so.

That's enough! But, in conclusion, what we need is a major re-evaluation of what really matters to our property industry. It was great once... and not long ago. Is it still great? Mmmmmmh! We have to have some fresh thinking. In short, we urgently need a new...

Go to page 19 for the answer to the anagram.

Is property a hedge against inflation?

This article is a short summary of the report entitled 'Property and inflation', which has just been published by the IPF Research Programme. The full report can be downloaded from the IPF website, www.ipf.org.uk.

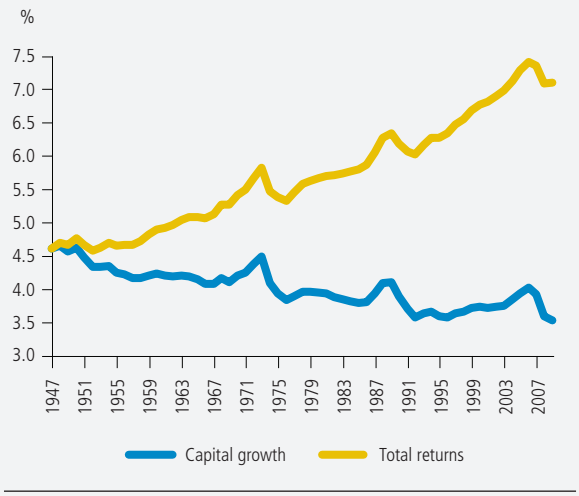
The research team, comprising **Neil Blake** (Oxford Economics), **Angus McIntosh** (King Sturge LLP) and **Chris Simmons** (Real Estate Forecasting Limited), was commissioned to explore whether, as is often claimed, real estate investment acts as a hedge against inflation or deflation in the UK and also in an international context. The team was then asked to consider the implications of the findings for portfolio strategy, investment targets and performance measurement.

Over the last 30 years, there has been an extensive body of work looking at the inflation hedging characteristics of various assets. Much of this work found that US equities were a perverse hedge on inflation i.e. equity returns were negatively linked to inflation. The assumption has been made that property, like equities, is a real asset, and so should offer a hedge against inflation.

Analysis of IPD data – UK

Figure 1 shows real returns to UK property investment in the UK since 1947, with all returns re-invested year-by-year and all expressed in 1947 prices.

Figure 1: UK property – real returns and components



Source: IPD, ONS, Oxford Economics

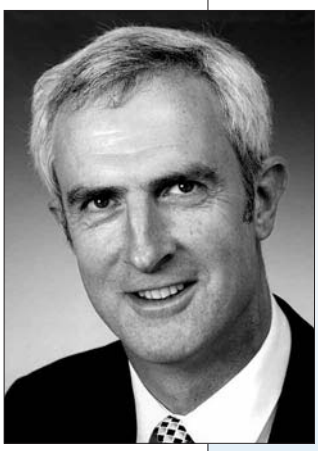
This analysis shows:

- There is a strong upward trend in real total returns but a number of very pronounced booms and busts produced some major fluctuations, with peaks in 1973, 1989 and 2006;
- Taking the period from 1947 as a whole, all of the real returns came from income rather than capital growth as real capital values actually fell; and
- All of the volatility also appears to have come from capital growth.

The observation of positive long-run real returns is not, however, sufficient evidence to be able to say that property investment acts as a hedge against inflation (that is, it reacts to changes in inflation, even though it may perform better than inflation long-term).

Neil Blake, Director of Economic Analysis, Oxford Economics

Figure 2 plots annual real total returns for the IPD All Property index against consumer price inflation. The coincidence of sharply negative real property returns and spikes in inflation in 1974 and 1990 stand out clearly, but year-to-year fluctuations mask the relationship for much of the rest of the period.



Angus McIntosh, Head of Research, King Sturge LLP

In an attempt to iron out short-term variation, Figure 3 shows the long-run real rates of return between various benchmark years, marking periods of relatively low and high inflation. The period from 1967-81 was chosen as these were the years characterised by cost-push inflation; oil prices trebled in 1973 and doubled again in 1980. (There are parallels in 2010 with world commodity prices to November up; oil +10%, food +25% and non-food agriculture – including cotton – +70%).

There is some relationship between nominal total returns and inflation. Both are low in the beginning and end periods and high in the middle, although simple observation is not enough to prove that property is an inflation hedge. What is interesting, however, is how capital growth appears to respond strongly to inflation while there is little relationship between income and inflation. This is consistent with the idea that property is a real asset.

Chris Simmons, Director, Real Estate Forecasting Limited

Analysis of IPD data – international comparison

It might be thought that the apparent negative long-run correlation between inflation and real income returns in the UK is largely a function of UK lease structures. To test this, the respective average real total returns were compared with inflation and GDP for the UK, Australia, Ireland and Canada, being the longest IPD series available. The results are summarised in Figure 4.

As the analysis is concerned with real returns, a negative inflation coefficient means that real returns fall if inflation increases, i.e. property is not a technical hedge against inflation. Many of the coefficients on inflation are not significantly different from zero. In technical terms, this means that a

Figure 2: UK, Real property returns vs inflation

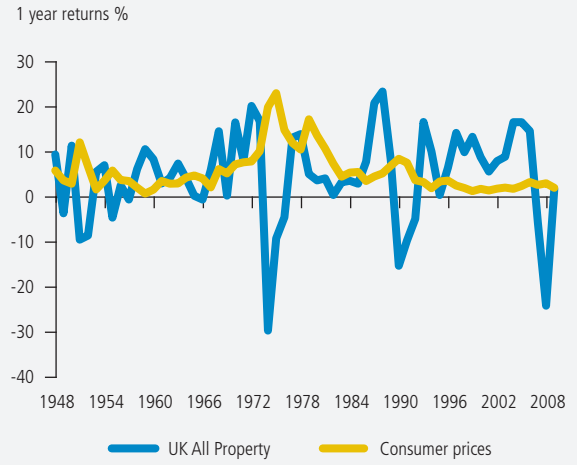
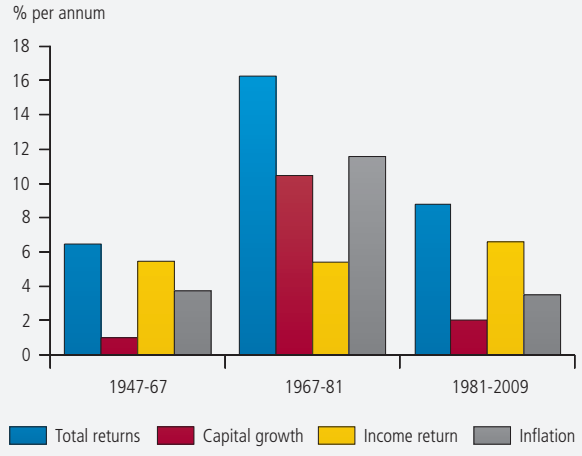


Figure 3: Nominal property returns and consumer price inflation



Source: IPD, ONS, Oxford Economics

negative coefficient does not prove that property is not an inflation hedge but this is not the same as saying that property is an inflation hedge. Given the sensitivity of the results to the time period considered, and noting that the analysis of the long run UK data argues strongly against the hedging powers of property, the international IPD evidence does not support the view that property investments in other countries do particularly better as an inflation hedge.

Property fails to hedge against inflation in each of the countries concerned and not just the UK. This is even the case in Ireland where, at first sight, there is a positive simple correlation with inflation, but once variations in GDP growth are allowed for, another negative relationship is evident. The importance of GDP growth as a driver of real total returns also shows for each country.

Figure 4: Real IPD All Property returns & inflation – international comparisons

	Average annual real total returns* %	Volatility**	Correlation with inflation**	Inflation coefficient	GDP growth coefficient
UK					
Total returns	5.6	4.7	-0.7	-0.49	1.92
Capital growth	-1.1	4.5	-0.7		
Income return	6.6	0.8	-0.2		
Australia					
Total returns	6.2	4.9	-0.2	-0.63	4.13
Capital growth	-1.2	4.8	-0.2		
Income return	7.4	0.4	-0.8		
Ireland					
Total returns	8.1	7.0	0.4	-0.43	2.91
Capital growth	1.6	6.6	0.4		
Income return	6.6	1.2	-0.2		
Canada					
Total returns	6.5	5.4	-0.4	-0.32	1.90
Capital growth	-1.3	4.9	-0.4		
Income return	7.8	0.8	-0.5		

*1985-2009 ** based on 5-year averages 1990-2009

Analysis of prime data

As the IPD data for most non-UK markets is not of sufficient duration, the team also looked at prime data. This section explores the relationship between prime and IPD data for City offices and then considers a broader selection of the inflation-hedging characteristics of a wider range of international prime data.

A comparison of returns for City offices between 1980 and 2009 showed:

- Total returns for prime outstrip IPD, at least over the period considered;
- The contribution of real capital growth is negative for both prime and IPD, but prime is substantially less negative than IPD;
- Real income is lower for prime than for IPD, presumably as a consequence of yields on prime properties being lower; and
- In both cases, more than 100% of the real total return comes from income rather than capital growth. In other words, income compensates for a real capital loss in both cases.

A statistical analysis of the prime City offices data shows:

- There is a negative relationship between real total returns for prime City offices and inflation. In other words, the data indicates that prime city offices are not a hedge against inflation although the coefficient is not statistically significantly different from zero;
- There is a very positive, very significant relationship with UK GDP growth; and
- There is a strong mean reversion effect (similar to that found in the analysis of IPD data). The negative coefficient on the lagged dependent variable means that several years of above average real total returns tend, all else being equal, to be followed by several years of below average returns.

Figure 5 summarises the statistical analysis of prime real total returns data for a selection of international markets and sectors. The time period for this analysis varies, and in some cases contains a mix of high and low inflation years while in other cases it covers predominantly low inflation years.

The 'mean reversion' coefficient is the estimated relationship between five-year real total returns in one year and five-year real total returns five years earlier. It reflects the effect of the property cycle, whereby high returns lead to new developments, which eventually force down rents and capital values. The choice of five years is arbitrary to some extent, but it does capture the main cyclical effects for most markets.

This international prime analysis indicates:

- Most markets show a negative link between inflation and real returns (i.e. property fails to hedge against inflation) but there are some notable exceptions, particularly West End offices and retail and industrial in Frankfurt, which appear to act as 'super-hedges' against inflation;
- In all markets there appears to be a positive correlation with economic growth;
- Three of the four industrial markets considered show incidences of being a hedge against inflation;
- The mean reversion tendency is apparent everywhere except in London industrials; and
- Although all incomes used have been adjusted for the lease terms for each market (where there is inflation indexation to the next break point this is calculated), there is no obvious pattern to suggest it changes the results, one city versus another.

The reason why West End offices appear to act as a super-hedge against inflation is that the West End is a prime location with a very limited capacity for speedy supply adjustment. The same might also apply to Paris offices, which also hedge inflation. Also, the dynamics between the property values (capital & rental) and land value as a proportion of total value may vary, from one city to another, which may influence the results. Frankfurt retail and industrials also appear to be a hedge against inflation,

Figure 5: Prime data – Responsiveness of real total returns

	Estimation period	Inflation coefficient coefficient	GDP growth coefficient	Mean reversion
Offices				
Amsterdam	1981	-0.53	4.74	-0.19
Frankfurt	1983	-0.03	7.77	-0.49
London City	1984	-0.37	8.80	-0.30
London West End	1984	4.50	10.43	-0.30
Paris	1983	0.35	6.54	-0.23
Sydney	1991	-0.78	14.22	-0.32
Tokyo	1990	0.48	4.81	-0.57
Retail				
Amsterdam	1990	-0.78	1.04	-0.31
Frankfurt	1990	5.47	1.70	-0.43
London	1990	-1.14	4.51	-0.27
Paris	1990	0.35	5.73	-0.39
Industrial				
Amsterdam	1990	-1.34	1.95	-0.09
Frankfurt	1990	5.28	2.63	-0.73
London	1990	1.29	5.08	-0.01
Paris	1990	2.60	6.02	-0.42

unlike the office market, but this may be due to the shorter time period, and in relation to the background economic market conditions.

Overall, the prime analysis tends to show property in a slightly more favourable light than the IPD analysis. In general, the inflation coefficients (or responses) are negative but not significantly different from zero, and some centres even show up as super-hedges. Some of this, no doubt, is due to the greater importance of capital growth to total returns when compared with the IPD data, and some may be still be due to the period analysed.

Analysis of alternative assets and property sectors

Figure 6 shows the relative real rates of return on different property sectors (IPD based) and equities and gilts in the UK.

This shows the negative relationship between real property total returns and inflation observed earlier and also shows that gilts also fail to hedge inflation, but equities do. Real equity returns are also unaffected by the rate of GDP growth while gilts have a negative relationship with GDP growth. Within the property sectors, the main differences are that retail is the worst inflation hedge and offices are most sensitive to GDP growth.

Figure 6: Real total returns in the UK

			Sensitivity to:	
	Volatility	Simple correlation with inflation	Inflation	GDP growth
All Property	5.0	-0.6	-0.44	1.93
Offices	5.2	-0.5	-0.35	2.52
Retail	4.4	-0.5	-0.75	2.14
Industrials	4.4	-0.3	-0.40	1.75
Equities	8.2	-0.2	0.00	0.00
Gilts	4.7	-0.6	-0.66	-1.03

Volatility and inflation correlations are based on 5-year moving averages. Note that asset class volatility and correlation calculations are based on 1975-2009 data. Sector volatility and correlations are based on 1985-2009 data.

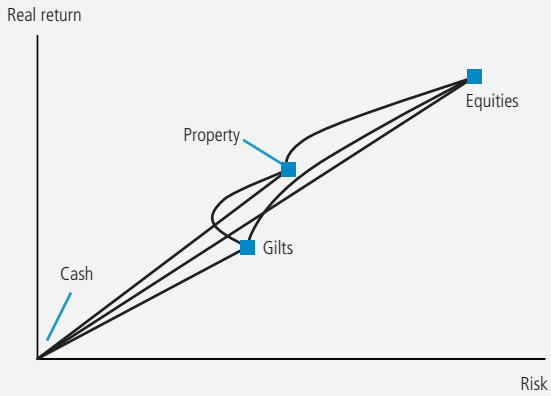
Implications for investment strategy

The results above indicate that UK property on the whole (industrials and prime property may be an exception) is not a perfect hedge against inflation. Equities are a much better hedge but property performs better than gilts. In addition, real property returns have been found to be positively related, and gilts to be negatively related, to real GDP growth. Investment strategy, however, has to take account of factors other than the expected return on alternative assets.

The optimal mix of assets in a multi-asset portfolio depends on the aim of the investor, the nature and duration of their liabilities, and the risks the investor is prepared to take. Figure 7 shows the cross-correlations for the four asset classes – cash, gilts, property and equities, based upon historical relationships and the assumptions detailed above. The cash return is at the origin; each asset class is compared with cash and then with each other. We can use these relationships to construct the efficient frontier, representing portfolios for which there is the lowest risk for a given level of expected return.

We know from the earlier analysis that inflation has a negative impact on real returns for property and gilts. Figure 7 shows that we also need to consider the sensitivity of the volatility of the different asset classes to inflation and GDP growth. The analysis shows that the volatility of real property returns are not sensitive to inflation but do vary with GDP growth. The volatility of gilts is also found to be insensitive to inflation but they are negatively related to GDP growth while equities' volatility are negatively related to inflation. These observations are of key importance for portfolio analysis. The total returns analysis implies that higher inflation does not affect real equity returns but reduces real property returns. The volatility analysis now shows that higher inflation will reduce equities volatility while leaving property volatility changed, which will further enhance the performance of equities in a high inflation environment (and vice-versa).

Figure 7: Base case



Scenario Analysis

The results shown in Figure 7 imply that variations in the inflation/GDP growth mix have implications for optimal portfolio composition.

Using a 'base case' view of sustainable growth and inflation outcomes of around 2.25% per annum for GDP growth and 2.0% per annum for inflation over a five-year period, Figure 8 shows the combination of assets at different levels of risk that produce the maximum real returns for a given level of risk on the efficiency frontier. They are all 'efficient' points, as defined by that criterion, and the chosen combination depends on the desired level of risk. So a more risk adverse investor content with volatility of 12.5% would opt for a mix of 25% property, 22% equities, 41% gilts and 11% cash, while the more adventurous investor, content to accept volatility of 20%, would opt for 31% property, 60% equities, 9% gilts and no cash.

Figure 8: Asset allocation – Base case

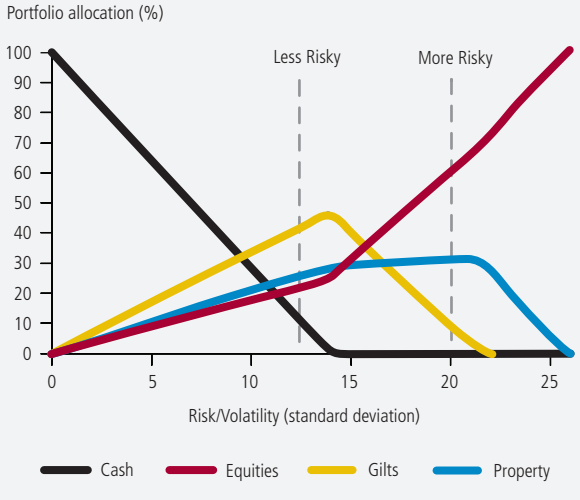
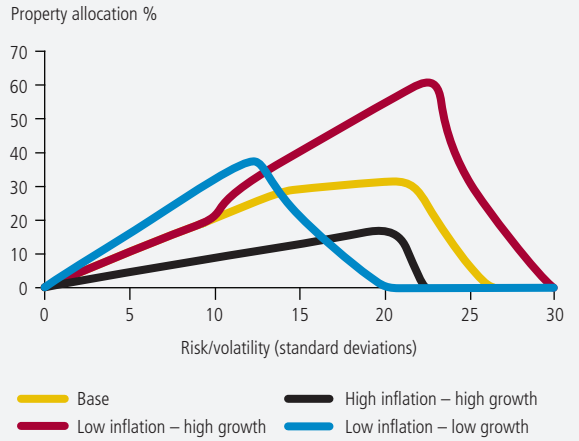


Figure 9 shows the modeled property allocations under a number of scenarios.

Figure 9: Allocation to property under different scenarios



Note: High inflation and low growth leads to a zero allocation to property

High GDP growth is generally beneficial for property allocations unless high growth is accompanied by high inflation. This means that the demand-pull scenario combination of high inflation and high GDP does not imply a higher property allocation than the base case, even though the expected real returns for property are higher because of the major link between GDP growth and real property returns. The reason for this is that high GDP growth increases the volatility of real property returns and the gap between the volatility of equities and property is further narrowed by the negative relationship between inflation volatility and the volatility of real equity returns. As might be expected, equities are the major winner in terms of predicted allocation in the demand-pull inflation scenario.

Figure 10 summarises the results by looking at the desired split between nominal assets (cash and gilts) and growth assets (equities and property), depending on the level of risk investors are prepared to take.

Implications for sectors

By using similar methods, we are able to analyse the appropriate splits between sectors, within commercial property. Here, there is no risk free asset, and the analysis is carried out using absolute (real) returns and deviations. By choosing different weights in portfolios (Figure 11 opposite) depending on whether inflation is high or low, you can either generate the same return (broadly) for a significantly reduced risk, or an increased return with no additional risk. Either selection is more efficient than the IPD weights.

The analysis shows that, given the assumptions used, the appropriate office weight depends on the tolerance to risk, the appropriate industrial weight depends on inflation, and the

Figure 10: Asset allocation by level of risk

Low risk

	High inflation High growth	High inflation Low growth	Low inflation High growth	Low inflation Low growth
Growth Assets	50%	50%	50%	50%
Nominal Assets	50%	50%	50%	50%
Split of Growth Assets:				
Property	10%	0%	35%	5%
Equities	40%	50%	15%	45%

High risk

	High inflation High growth	High inflation Low growth	Low inflation High growth	Low inflation Low growth
Growth Assets	80%	80%	80%	80%
Nominal Assets	20%	20%	20%	20%
Split of Growth Assets:				
Property	15%	0%	50%	0%
Equities	65%	80%	30%	80%

Figure 11: Allocation by sector

Low risk portfolio

	Low inflation	High inflation
Retail	75%	30%
Office	20%	20%
Industrial	5%	50%

High risk portfolio

	Low inflation	High inflation
Retail	45%	5%
Office	50%	50%
Industrial	5%	45%

appropriate retail weight depends on both inflation and risk tolerance.

Whilst it might perhaps seem surprising that the retail weight falls with higher inflation, and the industrial weight rises, this is because industrial property is a better hedge against inflation that retail. However, the fact that retail is such a poor hedge against inflation may be partly due to the data, in that it originally included retail warehouses and shopping centres as well as unit shops.

Analysis by GDP growth did not, in the sector case, yield very different allocations. This is due, in part, to the fact that, although office returns benefit more than other sectors from high GDP growth, the volatility also increases, leaving the allocation broadly unaltered. It is also influenced by the definition of risk and the point on the efficient frontier along which high or low risk is identified.

Key conclusions

- UK property delivers positive long-run real returns but in most cases it is not a hedge against inflation, where a 'hedge' is defined strictly as moving at the same time as inflation, or reacting to it, rather than merely keeping pace with it over time.
- Property does hedge against economic growth and, consequently, is useful for matching future assets to liabilities where future liabilities are nominal GDP related (i.e. wages).
- Total returns to the different sectors and to alternative assets, and their relative volatility, behave differently in the face of changes to inflation and GDP growth.
- The best scenario for property is the high growth – low inflation associated with the NICE era. The high inflation – low growth (stagflation) scenario is particularly bad for property. This implies that cost-push inflation, such as when commodity prices are rising faster than retail inflation, is not favourable.
- High GDP growth is generally beneficial for property allocations, unless high growth is also accompanied by high inflation. This means that the demand-pull scenario combination (when strong economic growth causes competition for resources and rising prices) does not imply a higher property allocation, except for investors prepared to take on high risk.
- In most economic environments, the property allocation tends to increase the more risk an investor is prepared to take on. However, the exception is the low inflation – low growth situation, where the property allocation is higher for the lower risk portfolios. In other words, in this environment, property becomes a safe haven.
- Within the property sector, offices and industrials are a better hedge against inflation than retail and should be preferred if there is thought to be a risk of high inflation.

INVESTMENT PROPERTY FORUM
Educational Trust
Patron Sir John Ritblat

IPF Educational Trust opens its PhD Studentship Programme for 2011

In 2010, the Investment Property Forum Educational Trust (IPFET) launched a brand new PhD Studentship Programme. The IPFET will now be inviting applications for the 2011 Studentship following a very successful first year which saw the Studentship awarded to Victoria Ormond of The University of Cambridge,

The IPFET awards one PhD Studentship per annum for a full time PhD.

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 and applications will be judged with a priority given to those deemed to have tangible outcomes with an 'enduring benefit' for the industry as a whole.

Application forms and guidance notes will be available from January 2011 on the IPFET website www.ipfet.org.uk. The closing date for the Studentship beginning academic year 2011 is **31st March 2011.**

If you would like any further information on the **IPFET PhD Studentship Programme** please see www.ipfet.org.uk or contact Vicki Law: **vlaw.IPFET@gmail.com**

The causes of portfolio risk

Gerald Blundell

This article is based on the study carried out by Gerald Blundell, Malcolm Frodsham and Roberto Martinez Diaz under the IPF Research Programme. The full report, 'RISK WEB 2.0 – an investigation into the causes of portfolio risk' is available on the IPF website, www.ipf.org.uk

Traditionally the property industry has defined portfolio risk in terms of the tracking error of portfolios – the extent to which through time the portfolio return deviates from benchmarks. However these variance-based measures of risk suffer from a number of drawbacks:

- They are non-diagnostic; a tracking error gives no indication of what caused it;
- They are retrospective; measures of variance depend on long strings of past data which in all probability relate to properties no longer in the portfolio;
- The underlying assumptions of using standard measures of variance frequently imply a market that is much more efficient than empirical observation has found it to be; and
- Past volatility is a poor predictive guide to future relative performance; the past is not a good guide to the future.

It was to overcome these problems that the concept of a Risk Web was launched in 2003. This is a diagram that charts portfolio scores on 12 risk factors relating to tenant quality, lease length, stock concentration and so on. Each portfolio has a profile on the Risk Web, which is compared to its benchmark so that the relative risk exposure across a range of measures can be identified.

The advantages of the approach are that it was clear what factors were behind the risk; it looked forward, not backwards; and it dealt in terms that managers could use to adjust their portfolio's risk. The selection of the factors was partly justified by the analysis of how the factors correlated with subsequent differences in portfolio returns, but owing to the absence of data was in part conjectural.

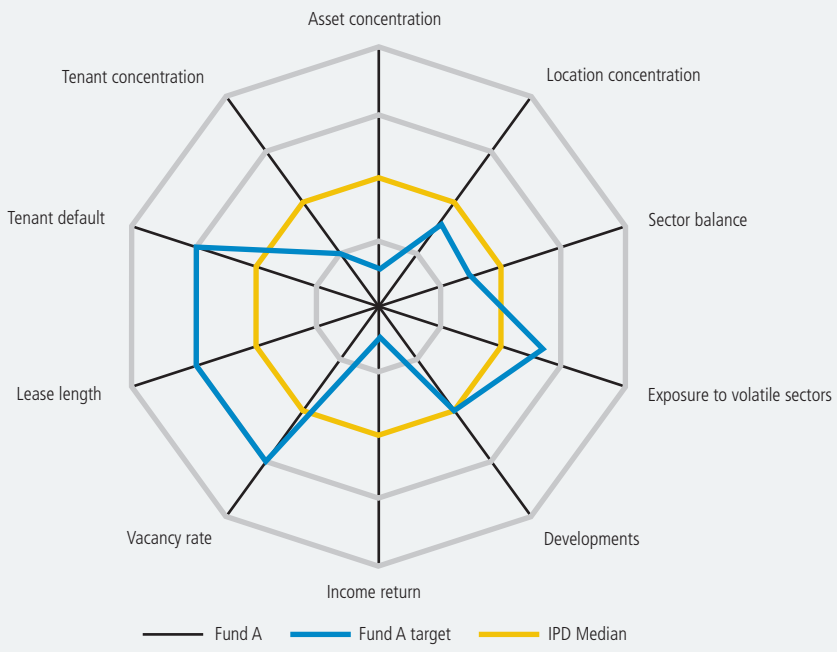
The objectives of this study are threefold:

- To update the original 2003 Risk Web 1.0 analysis now that longer and more extensive time series are available, with a view to developing a better understanding of what causes portfolio risk and how these causes vary through the cycle; plus introducing factors such as leverage that were not included in the original study.
- To develop quantitative models of portfolio risk to see how much can be systemically explained. It should be noted that this is not a forecast of market risk per se; it is an attempt to predict how a portfolio will behave relative to the market's ups and downs. In this study, portfolio risk is defined as this residual difference in performance between the portfolio and the market; the greater the difference, the greater the risk.

Malcolm Frodsham, Research Director, IPD

Roberto Martinez Diaz, Statistician – Research Department, IPD

Figure 1: Risk Web 1.0, 2003



- To identify those evergreen risk factors usually present through the cycle.

Study approach

The study identified 43 factors potentially pertaining to portfolio risk and drawn from IPD's records. They related to some 250+ portfolios over the period from 1998 to 2009. The factors fall into eight groups. The first five measure the diversification in the portfolio in different dimensions; locations, type, remaining lease length, tenants and lot size. In each of the five cases, four alternative measures of diversification are tested. The other 23 factors are classified broadly under growth, income and manager activity. All of the factors included in Risk Web 1.0 are included, plus a number of tenant-related factors that could not be analysed in 2003.

These factors were correlated against portfolio risk in subsequent years. For the purposes of this study, risk is defined as the difference (positive or negative) between a portfolio's return and that of the unweighted average of the sample. This is referred to in the study as 'absolute' risk.

A positive difference (outperformance) is treated as just as risky as a negative difference. As well as absolute risk, two other definitions were used on occasion; 'nominal' risk with the plus and minus signs restored, and 'downside only' risk, where only negative differences were taken into account. These proved useful in identifying factors that only kicked in when capital values were under pressure.

The factors were analysed in three phases. First, all the factors relating to direct properties were correlated to differences in return based on direct properties only. This effectively repeated the Risk Web 1.0 approach. Then secondly indirect assets were taken into account. These are largely exposure to co-mingled vehicles of various sorts, but also include derivatives, quoted company shares and any asset not classified as a direct holding. The factor, described as '%indirect' was the only available proxy for the growing exposure of portfolios to vehicles, a factor not included in the original risk web. Thirdly, leverage was introduced into the analysis, focussing on the AREF sample of 50+ portfolios and using leveraged returns as reported by PPFI.

At both the second and third stage, answers to the same three questions were sought: How much did indirect assets and then leverage increase risk; Did their effects vary through time; and what effect did indirect asset and then leveraged returns have on the other factors?

The results of these exercises produced the basis for several models of future risk, some with interesting levels of significance. It also provided a short list of factors for a risk scorecard.

Results: Directly-held assets

Over the 11-year period studied, total return (TR) risk one year forward (TR1) rose steadily – in 1999 average TR1 was +/- 1.9%, by 2009 it was +/- 5.2%. The rise was due almost entirely to a rise in capital return differences (CG1), differences in income returns (IR1) being largely static at around +/- 0.7%. It probably reflects the increase in the presence of specialist funds, as segment concentration was also rising throughout the period; while vacancy rate followed a cyclical but rising pattern especially over the last couple of years. From 2006, when real capital returns went negative, TR1 and CG1 spiked upwards as portfolios' reaction to events diverged. At the same time, the portfolios' dispersion around these means increased, especially after 2005. In 2009, mean TR grew rapidly, as did the dispersion around it. It will be recalled that 2009 saw a rapid recovery in values driven by yield compression at the prime end of the markets. Clearly not all portfolios shared in the recovery.

Why should TR1 and CG1 have jumped so much in 2008 and 2009? Inspection of average factor values reveals that by the end of 2008 several risk factors were sharply higher. Apart from vacancy rate, 2008 saw a rapid increase in sales – net investment fell from +0.8% of end year value in 2007 to -7.2% in 2008. These factors could have caused fund returns to diverge in 2009.

So which evergreen factors proved to be significantly linked to TR1 more years than not? The majority are structural measures of various types of portfolio concentration, region, segment, property type, stock, tenant and the timing of lease termination. A consistent theme is the need to diversify in a number of dimensions to reduce risk, a key feature of Risk Web 1.0.

The full list of factors identified was reduced to 12 because some factors were highly correlated with other preferred factors. When two factors are highly correlated, they are effectively linked to the same part of TR. So to include both is to double count their influence. These 12 factors divide into two groups; nine evergreen ones that are significantly related most of the time and three that are cyclical, in that they become significant after periods when real capital values have been falling. The nine evergreen factors are as follows:

- Property type concentration
- Regional concentration
- Weighted type tracking error
- Lease length concentration
- % value of five largest assets
- average lot size
- tenant concentration
- relative equivalent yield
- TR1 in the year

Of these, only relative equivalent yield was linked using a downside only definition of risk – suggesting that relatively low yields may be associated with lower relative returns, but the reverse is not proven (that high yields link with higher returns).

The three cyclical factors and the years they were significant are as follows:

- % value in development: 1999, 2003, 2008, 2009
- relative covenant strength: 2002, 2003, 2008
- vacancy rate: 2002, 2003, 2005, 2008, 2009

The years when these factors significantly correlated with subsequent TR1 are mainly following a period when values were under pressure.

The study found that correlations tended to improve when a two or three year time horizon was used. A possible explanation is that property portfolio returns are frequently subject to idiosyncratic events such as a change in valuer, the addition or removal of very large assets, changes in manager, the tax environment etc. Over two or three years there is an increasing chance that the effect of these events will self cancel, leaving a greater proportion of potentially explainable variance in returns behind. The finding was reflected in the better quality of regression results when TR2 and TR3 were the dependent variable – lending weight to the practice of judging portfolios' relative performance and risk over several years, rather than just the latest one.

The typical tracking error in total portfolio returns is in the range of +/- 2% to 3% in any one year. In 2008/9 it has been substantially higher; greater market volatility has exposed greater differences in the way portfolios perform.

Factors relating to portfolio concentration are the most reliable indicators though time and across the different components of return. Factors relating to growth (development, covenant strength and vacancy rates) are most significant when real capital value is falling.

Analysis of multi factor models on recent years' data suggests that, although twelve of the candidate factors are linked to risk, they do not readily combine into a model that could be used for predictive purposes.

Adding indirect assets

Adding indirect assets' returns to direct ones marginally increased portfolio risk. This may be a function of indirect exposure to leverage, although the effect is offset by the extra diversification offered by some vehicles.

However only in two of the years did fund exposure to indirect assets significantly correlate with TR1. Using overall portfolio returns had little impact on the direct asset only results reported above.

The effect of leverage

Leveraged returns produced much higher levels of TR1 than either direct only or total asset returns. It also correlated strongly, positively and significantly with TR1, with the level of significance rising considerably over the last couple of years.

The study found that the level of LTV at end 2008 was significantly correlated with unleveraged returns, a co-efficient of 0.35. In other words, funds with relatively risky portfolios had been seeking to enhance their returns further with debt. Similar correlations were found in 2002, 2006 and 2007, years when some of this debt would have been originated.

The influence of debt through the cycle was analysed in terms of nominal and downside only measures of TR as well as absolute return differences, the measure largely adopted by this study. LTV is positively and significantly correlated in all but one year, 2005. The picture changes in the light of nominal measures. In the first part of the cycle, LTV is positively correlated; the extra risk paid off with higher returns. This changed in 2007, the correlation sign turns strongly negative as capital values fell and it stayed negative in 2008 and 2009.

Because the use of leverage directly affects returns, debt drowns out the effect of other sources of risk. In their absence, LTV dominates the causes of risk. This explains why apparently disparate asset classes suddenly started to show high correlations during the financial crisis. Although their fundamental characteristics and risks were different, the presence of debt rendered them as one; or if not that then similar enough for the values to move in concert.

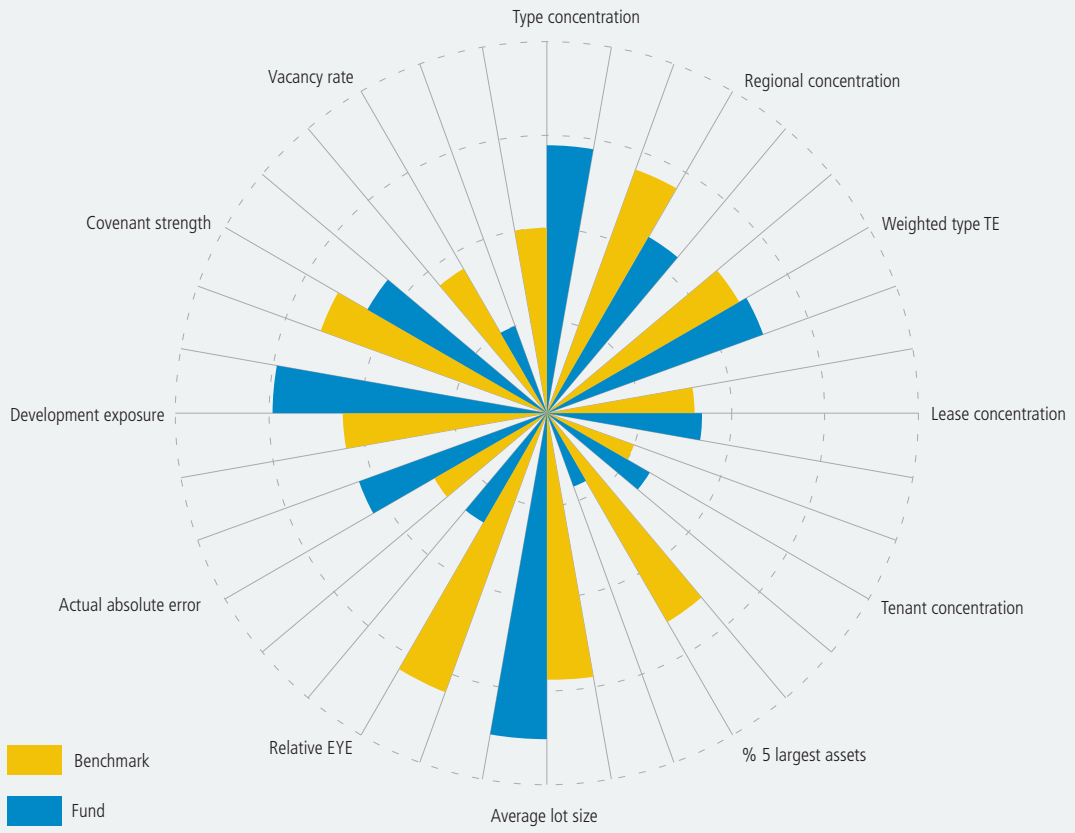
Adding debt to a portfolio increases its risk, a risk that rises exponentially as either debt is increased or values fall. A key band between 30% and 40% LTV seems to exist at end 2008. Below this band, modest levels of debt have a limited impact on risk; above it and as LTV rises risk soars.

While the results on leverage underline the logic of distinguishing between core plus, value added and opportunistic fund styles on the basis of leverage; they suggest that other factors might be taken into account as well when defining fund style. Through time it is clear the level of gearing varies both as a function of capital returns and also as a result of management decisions. It is therefore quite possible that the level of gearing could reduce relatively quickly, revealing again the risk factors previously masked by leverage.

Towards a risk scorecard

Although models of risk could not be developed that were robust through time, the results of the analysis did provide enough material for the development of a risk scorecard as a number of evergreen factors emerged as relevant in most years. In the full report there are several illustrative methods for compiling the individual factors together into a risk scorecard. The methods were back-tested against the actual portfolios

Figure 2: Risk Web 2.0, 2011



used in the study to ensure the overall scores emerging correlated with the actual TR1s experienced by the portfolios.

Concluding comments

What does this study tell us that we didn't know before?

First, we now know there is an alternative approach to dealing with risk than the retrospective, non-diagnostic study of past return volatility. The study has identified a set of factors that both practical experience and statistical analysis suggest influence future risk in portfolios. It was striking that only one variance based factor found its way into the final risk factors selected. Many of the volatility based measures failed to relate significantly in more than a few of the years covered by the study; and a number of them were strongly intercorrelated and so could not all be used. While this came as a surprise, perhaps on reflection it should not. After all, if past performance is a poor guide to the future, why should the volatility in that performance be any better?

Second, the study highlights the critical role of leverage. This has emerged as a feature of markets over the past decade and it is here to stay. The importance of leverage as such was not so much of a surprise as this is well documented; rather it is the way it drowns out the other risk factors by changing portfolio returns. Whilst they retain a latent influence waiting to be seen when the volume of leverage is turned down, any risk mitigation they offer is masked while leverage is in place.

It is hoped that the analyses reported here will stimulate thinking about risk in property and throw up new lines of analysis that the authors have not envisaged. For too long risk in property has been in thrall to conventional capital market theory; it is time property developed approaches more suited to its intrinsic characteristics as a distinct actively managed asset class.

Occupier Satisfaction Survey 2010

Stuart Morley, Head of Research, GVA Grimley Ltd

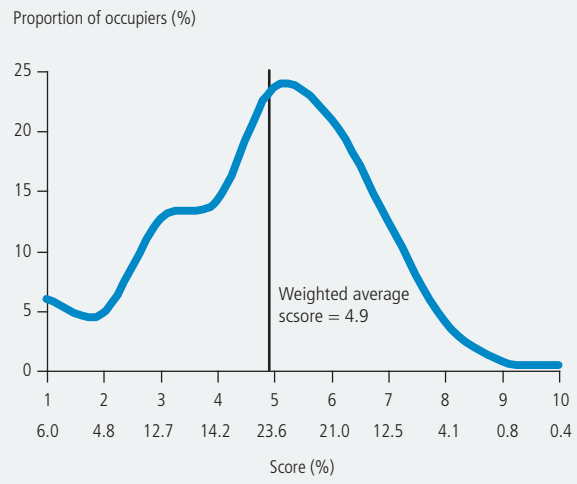
The fourth Property Industry Alliance (PIA) and CoreNet Global Occupier Satisfaction Survey was published in September. It collected the views of a range of occupiers, detailing their experience of working with landlords over the past 12 months. This year saw a change from previous years in the form of the questionnaire, which is now more detailed and is based on the Code for Leasing Business Premises in England & Wales, 2007. A Steering Group from the PIA and CoreNet Global devised the questionnaire and was responsible for emailing the questionnaire to occupiers. Results were collated, analysed and presented by GVA Grimley Ltd, a member of the Steering Group. This change in the questionnaire means that it is not possible to compare directly the results from this year's survey with earlier surveys, but the general tenor of this year's results echoes those of the previous three years.

The 'All UK commercial occupiers' score in the survey was weighted to reflect the sector breakdown of the UK's leased commercial property stock and the distribution by size of company in the UK economy. This was necessary as the sample sizes for the SME group and the industrial sector in the survey were relatively small compared with the large occupiers and the retail and office sectors.

A detailed analysis of the findings is available from www.occupiersatisfaction.org.uk.

Key Findings

Figure 1: Satisfaction with the relationship with your landlord(s)



The overall average weighted score was 4.9 out of 10 (with an unweighted score of 5.1) from all commercial property occupiers (where 1 is extremely dissatisfied and 10 is extremely satisfied). This suggests that, on the whole, occupiers feel that UK landlords provide a moderate level of service, with plenty of room for improvement. This mirrors the findings of the three previous surveys.

By sector, the results indicate that those from the industrial sector (score of 4.6) were less satisfied than those from the office sector (score of 5.2) or the retail sector (score of 5.1). However, the smaller response rate from industrial occupiers may have influenced this figure. Generally, smaller occupiers (Small and Medium Enterprises [SMEs] with 250 employees or less) were less content (score of 4.2) than larger occupiers (score of 5.3). The previous three surveys had similar findings.

As the first chart shows, although the overall weighted average score was 4.9, a considerable number of occupiers were either less or more satisfied with their landlord(s) and the results were not evenly distributed. 23.5% were very dissatisfied (with scores of 1, 2 or 3), whereas only 5.3% gave a score of 8, 9 or 10, indicating a very high level of satisfaction.

A high 80.8% of occupiers felt that their relationship with their landlord had remained fairly constant over the previous 12 months, while a small number (13.2%) felt that it had deteriorated ('worse' and 'much worse') and an even smaller number (6%) thought that the relationship had improved.

Areas where satisfaction with landlords was highest

Occupier satisfaction with the lease negotiation process, in terms of rent review terms and conditions achieved, was higher (score of 5.8) than for any other area. This issue also had the best improvement levels, with 24.2% of respondents saying that they felt the process had become better or much better, compared with 12.6% claiming it had become worse or much worse. This net improvement of 11.4% may well reflect market conditions moving in favour of tenants.

Of those occupiers that agreed a lease in the last 12 months, 57.6% obtained alternative rent review terms and 62.6% obtained other concessions. 29.8% obtained both. 11.8% obtained neither and in 2.2% of cases the landlord increased the rent.

The leasing process had a weighted average score of 5.5, suggesting that, overall, respondents had an average level of satisfaction. But there had been a net increase in satisfaction, with 17% claiming the process had become better and only 10% feeling that it had deteriorated. The average score of 5.5 also hides an interesting difference in the levels of satisfaction between the size of companies, with SMEs scoring significantly lower (4.5) than large companies (6.1).

Over 80% of respondents across all three sectors had agreed to a new lease within the last 12 months. Just over 30% had agreed a lease of 1-5 years, just under 46% had agreed a lease of 6-10 years and a minority of 24% a lease of more than 10 years.

For the rent review process as a whole, occupiers gave an average score of 5.4 out of 10. Nearly a quarter of respondents felt that the situation had become worse over the last 12 months compared to less than half as many who thought that things had improved. It is also worth highlighting the considerable difference in scores awarded by each sector, with offices (score of 5.9) and retail (score of 5.5) being more satisfied than the industrial sector (score of 3.9).

Over 90% of occupiers said that they were either 'always' (57.6%) or 'usually' (33.1%) professionally represented by a surveyor in rent review negotiations. Of those who had a rent review referred to a third party for settlement in the last 12 months, 86.5% felt that the process was worthwhile.

Areas where satisfaction with landlords was lowest

Landlords' service charge arrangements did not fare particularly well, achieving an average score of 4.2 by occupiers. The survey revealed a number of areas where occupiers felt that their landlords could be more transparent and provide more details on costs involved in service charge agreements. 19% of occupiers felt that service charge arrangements had worsened over the last 12 months, compared with only 4.6% who felt they had improved.

With a low average score of 4.0 out of 10, and over 45% of respondents awarding a score of 3 or less, a significant proportion of occupiers felt very dissatisfied with the application for consent process:

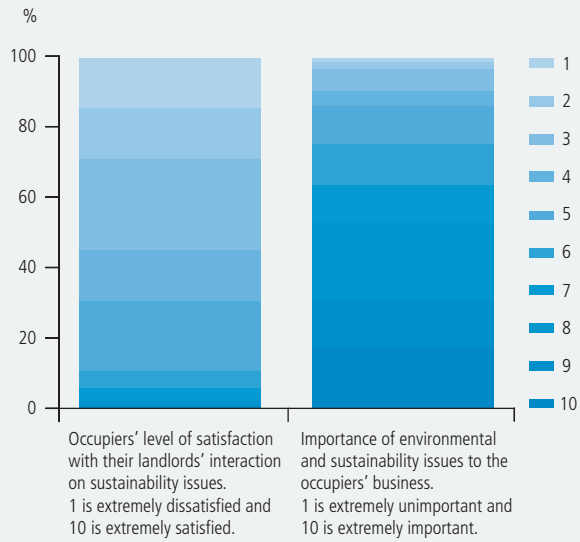
- 43.6% of occupiers claimed they waited more than four weeks to receive a response to their initial application and 30.8% said they had to wait more than 12 weeks to receive a decision.
- 28.8% of occupiers believed that the process had become 'worse' or 'much worse' in the last 12 months, while only 2.9% felt that it had improved.
- SME occupiers were more pessimistic (score of 3.3) than larger occupiers (score of 4.2).

Environmental/sustainability issues received the lowest level of satisfaction by far from occupiers in the survey, illustrating that landlords are not adequately working with their tenants. An overwhelming 89% of occupiers indicated dissatisfaction when asked about their landlords' interaction with them regarding sustainability issues. The average weighted score was only 3.5, with over 50% scoring only 1, 2 or 3 out of 10.

The survey indicated that landlords' levels of interaction on environmental issues had largely remained unchanged compared to 12 months ago, with 84% of occupiers replying that it was 'about the same'. Only 7% replied that it was 'better', with 9% noting that it was either 'worse' or 'much worse'. This is despite an increase in both environmental related legislation and occupier interest.

There is a large gap between landlord interaction on environmental issues and occupier views regarding the importance of environmental sustainability issues to their business, as the second chart shows. Occupiers gave a high average score of 7.1 out of 10 when asked about the importance of sustainability issues to their business, and 47.9% said the issue was 'more important' than it was 12 months ago.

Figure 2: Satisfaction and importance of sustainability



The importance that occupiers place on environmental and sustainability issues is high in all sectors. Almost 30% of office occupiers view these issues as extremely important to their business, attributing an importance rating of ten out of ten. 85% attribute the issues some level of importance, this level dropping slightly to 82% for industrial occupiers and 73% for retailers. Perhaps not surprisingly, sustainability issues were considered to be more important for larger occupiers than for smaller companies, with scores of 7.7 and 5.9 out of 10, respectively.

Conclusions

The survey covered occupiers' attitudes towards landlords and how that is changing. It did not cover landlords' attitudes towards occupiers, so it is perhaps not surprising that the scores achieved appear relatively low. The results in this survey are similar to those in the three previous surveys, even though the specific questions were different.

Clearly the state of the economy may also have influenced occupiers' attitudes, but the survey results suggest that landlords have some way to go before occupiers think that they receive a good service. This is particularly marked for small occupiers and particularly noticeable with environmental issues. It will be interesting to see what improvements occur over the next 12 months as the economy and occupier market gradually improve.

Financial modelling in a volatile market

Andrew Bell,
Lawyer

Property companies and traditional institutional investors continue to rely on discounted cash flow (DCF) and net present value (NPV) calculations when preparing investment or development appraisals. Although sensitivity analysis can model a range of key variables, these finance techniques rely ultimately upon assumptions of stable market performance once a project has been approved. The models also have a tendency to isolate property decision-making from the general economic climate. This article explores the potential for additional finance modelling techniques to enhance corporate decision-making in a volatile market.

Changing market dynamics

There is no doubt that the market has become more volatile during the credit crunch. Market swings are not a new phenomenon in the real estate industry, although the severity of the collapse in asset values between 2007 and 2009 is unprecedented. There are, however, a number of structural changes to the nature of the market which have implications for the continued reliance on DCF and NPV methodologies including:

1) The closer integration of the real estate cycle and the wider economic cycle primarily driven by UK bank exposure to real estate debt, direct exposure of the capital markets to real estate funding through securitisation and CMBS programmes and, in relation to the City office market, the increasing dominance of the Financial and Business Services sector as the primary occupier and the primary source of real estate investment funds. These factors necessitate the inclusion of external factors into real estate financial modelling.

2) The abandonment of long-term buy and hold strategies by leading property companies will lead to shorter hold periods for properties, as will the emergence of private equity investors who acquire properties intending at the outset to hold for a limited period with exits planned over a three- to five-year window. Shorter hold periods draw focus on capital value appreciation or opportunistic speculation on short-term rental growth – neither of which is dealt with particularly well by traditional modelling techniques.

Additional techniques to enhance DCF and NPV modelling

Traditional financial modelling techniques can be enhanced by the application of sensitivity analysis, the adoption of scenario analysis and by balancing initial research with complementary valuation techniques such as breakeven analysis. However, these additional checks and balances still rely upon assumptions of static predictable performance once a project or investment has been approved.

'Discovery driven planning' and 'real options analyses', two techniques borrowed from general investment finance, have the potential to add to the existing range of financial evaluation tools.

Discovery driven planning

Discovery driven planning sets threshold financial performance markers and requires an assumptions checklist, ranking the underlying assumptions in priority order. The assumptions can then be tested in priority order at each approval or implementation stage leading to the swift abandonment of any project for which critical assumptions are proven to be incorrect or undeliverable. A renewed focus on transaction uncertainties and a shift away from pure financial performance analysis concentrates attention on the potential downside of any transaction or project.

Real options analysis

Real options analysis is designed to be carried out before a transaction is approved but differs from the standard techniques as it allows the user to price the financial implications of changes that can occur during the course of a project or an investment hold period.

The methodology places a financial value on the discretionary ability to cancel, postpone or increase expenditure on an investment project after commencement. This requires an analysis of the project in order to break it down into distinct phases representing individual decision points where the option to vary arises. Real options allow managers to account for the value of the inherent flexibility of investment projects. The analysis relies upon assumed values applied to the different permutations at each decision point. In effect, initial expenditure on any project is treated as a fee to secure the option for subsequent discretionary expenditure. The analysis is best suited to phased projects, such as site assemblies and subsequent development phases, but can be used to model the hold period for a standard investment purchase.

Difference between real options and traditional option contracts:

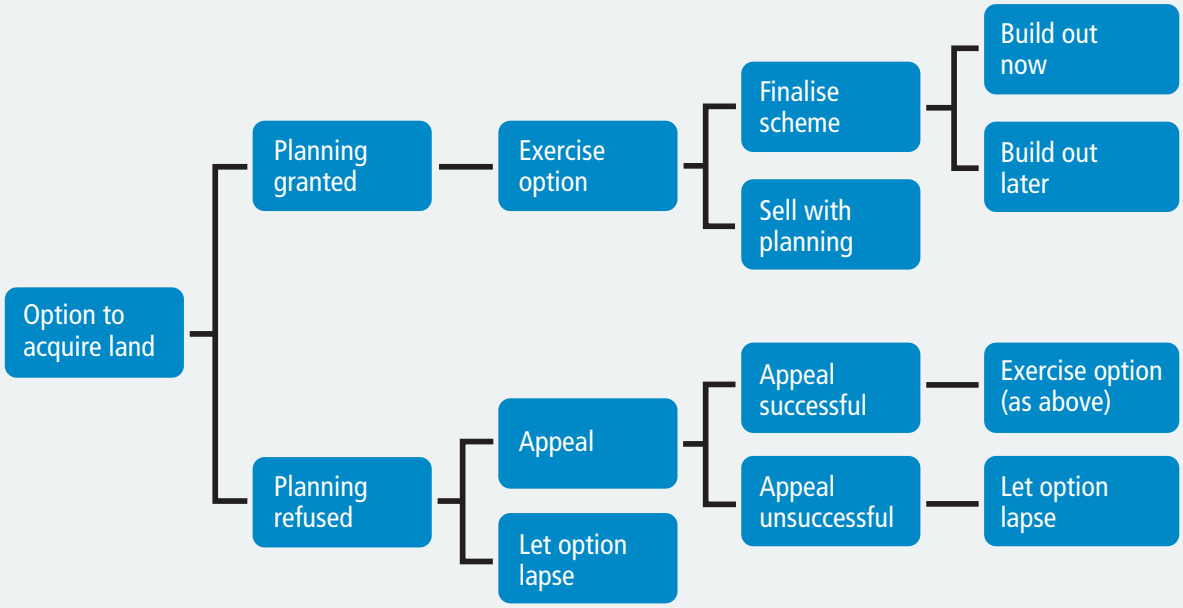
The key differences between traditional options and real option analysis focus on three key areas:

1) For real options analysis, the value of the underlying asset is not expressly known and is predicted based on market information;

2) For real options analysis, there is no absolute clarity regarding the option fee payable at any decision point and the consideration needs to be re-evaluated each time a phased decision is made; and

3) Real options analysis does not assume that the option holder has exclusive rights over the asset to be acquired – this allows the mathematical analysis of rival developments or investment products that can impact upon any investment decision.

Figure 1: Decision points during a development project



How do they work in practice?

Figure 1 provides a simple illustration of the common decision points for a development project.

A valuation is placed on each decision point outcome and tracked back to provide a present value at the outset of the transaction. Valuations are prepared using an algebra-based, binomial decision tree calculation. These can be prepared using spreadsheet software. A sample model is shown in Figure 2.

Practicality of using real options?

The use of real options analysis requires the timely execution of individual decisions as value can be lost by the early or delayed exercise of option decisions. The adoption of this methodology would require careful co-ordination between the transaction and implementation teams if these are different individuals. Optimal decision-making can be promoted by the re-gearing of project management to reflect the real option decision point structure and by appropriately rewarding effective implementation.

Conclusions

DCF and NPV analysis are deeply engrained in the operating architecture of professional property investors. Discovery driven planning and real options analysis offer additional analytical tools to complement the existing techniques. Both draw a clear focus on the potential downside of any investment transaction or project and allow for the more direct application of corporate risk management thinking to individual transactions, particularly the potential impact of significant changes to market conditions.

Real options analysis is particularly relevant to option contract-based projects, particularly high-value development projects or complex multi-component site assemblies carried out over a period of time. Real options can allow for more accurate modelling of such projects and can reveal a more accurate value for individual component parts of any project, which can be significantly different from the market value agreed under an option contract.

The recent arrival of private equity investors in the UK market e.g. Blackstone's purchase of a 50% stake in The Broadgate Estate should also encourage the adoption of a more finance-based approach to investment project evaluation. Traditional investors will then be better placed to gauge the perceived value of a project to newer entrants – ensuring that values agreed reflect the true views of all transaction parties.

Figure 2: Valuing a real option

Example

Present Value (PV)	100
Time Periods (T)	3
Exercise Price	95
Up Movement (u)	1.2
Interest Rate (%)	3
Down Movement (d)	0.833
Dividend Payment (%)	0

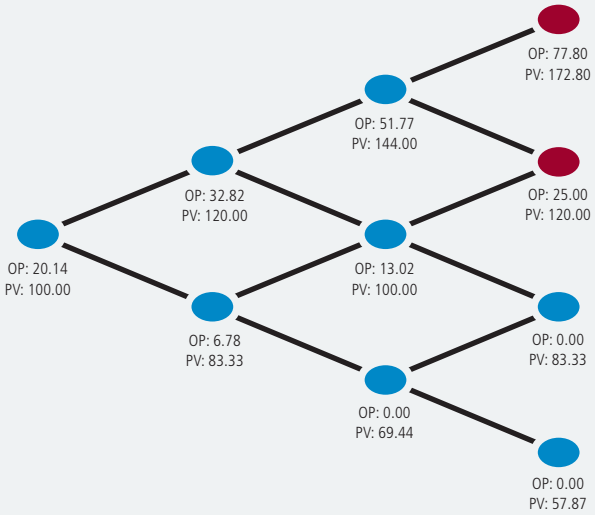
Key

PV: Present Value

OP: Option Price

Don't exercise option

Exercise option



Steps to creating a binomial tree for valuing a real option:

1) Work from left to right to determine the present value (PV) at each node

2) Calculate the potential final project values at T3 by subtracting the exercise price of the ultimate option

3) Calculate the project values at T2 in a similar manner as above and also using the replicating portfolio technique to determine the option value (OP)

4) Calculate the project values at T1 and T0 also using the replicating portfolio technique to determine the option value (OP)

At each node if the value of calculated option is less than the value of keeping the option alive then terminate the project.

The answer to the anagram in Robert Houston's article on page 3 is:

L_1 O_1 N_1 G_2 T_1 E_1 R_1 M_3 V_4 I_1 S_1 I_1 O_1 N_1

UK Consensus Forecasts
November 2010

Louise Ellison, Research Director, IPF

The Q4 2010 IPF UK Consensus Forecasts show expectations for 2010 stabilising as we approach the year end but continued and deepening uncertainty for 2011. Both capital and rental value growth figures have improved marginally across the sectors for 2010 although rental value growth remains negative other than for offices. The figures for 2011, however, have been revised downwards again. Rental value growth is forecast to continue to fall for industrial, standard shops and shopping centres and only offices are expected to show positive capital value growth. The total return forecasts have been revised downwards across all sectors except retail warehousing which has ticked up slightly.

The weak forecasts for 2011 are a reflection of continued weak expectations for the economy more broadly. The Treasury consensus forecast of GDP for 2011 is 1.8%[1], not much ahead of 2010 at 1.7%. Although CPI and RPI are forecast to fall they remain above target with the consensus CPI forecast for 2011 now 2.6%. Real household disposable income is forecast to fall further next year.

Economic growth this year has been driven by the construction and business services and finance sectors but the rate of growth has slowed in Q3. After four quarters of growth the economy has made up approximately half of the output lost during the recession. Whilst it could be expected that there would be substantial capacity within the economy to allow more rapid growth in productivity without putting pressure on prices, the substantial reduction in fixed capital formation since 2007 may be a hindrance to this. Given these factors combined with the continued upward pressure on prices from fuel in particular, the outlook for 2011 is unsurprisingly pessimistic.

The fragility of the economy is further reflected in the employment data. Whilst unemployment was down marginally at 7.7%[2] and the employment rate was up, the underlying trends for employment suggest businesses remain wary of expanding and continue to cut costs where possible. This quarter saw a fall of 62,000 in the number of people in full time employment and an increase of 67,000 in the number of people working part time because they can not find full time work. The total number in this situation is now recorded at 1.15 million. The increase in employment within the figures this quarter is being generated by this increase in part-time work and an increase in self-employment. To add to the pre-Christmas gloom the number of job vacancies has dropped and annual earnings growth remains below inflation at 2% (including bonuses).

These employment figures suggest consumer expenditure is unlikely to grow significantly over the next 12 months. With real household income forecast to fall, the downward revisions to the retail sector forecasts are no surprise. The retail sales data for 2010 show the volume of sales in the year to October fell 0.1%[3] with predominantly food stores seeing the biggest decline. The most buoyant sector in terms of retail sales was games, toys and hobbies. This has been reflected in prices with computer games bought on the high street in particular seeing a sharp increase. These figures predate the pre-Christmas launches of new product ranges.

Overall the economic outlook remains weak and the property forecasts for 2011 reflect this. One of the most worrying factors could be the combination of stubbornly high inflation in the face of weak economic growth. Upward pressure is being exerted on the CPI figures by the continued rise in fuel prices. There are also growing concerns with regards food prices for 2011 in light of crop failures in 2010. However, so far in the UK food prices have been exerting downward rather than upward pressure on prices. The price of meat and vegetables has fallen, in particular potato crisps, cauliflowers and pork have all seen prices fall as supply has improved. So that's the IPF Christmas lunch taken care of!

Fixed investment is forecast to increase by 3.6% in 2011 and logic would suggest there is capacity for expansion within the economy so the potential for better prospects in 2012 can be seen. There may well be light at the end of the tunnel.

Key points

The IPF UK Consensus Forecast All Property total return for 2010 has stabilised this quarter showing a small increase from 13.2% to 13.6%. However the total return forecasts for 2011 have weakened again.

- The slightly more positive expectations at the year end are being generated by marginally less pessimistic rental value growth figures for 2010 and stronger capital value growth forecasts. Rental value growth expectations remain negative however, for all sectors except offices in 2010.
- The consensus forecast of total return for 2011 in contrast remains on a resolutely downward trajectory for all sectors, driven by weaker rental and capital value growth forecasts.
- The five year view remains broadly similar to the last round of the survey showing above inflation total returns for all sectors.
- The more recent forecasts are the more optimistic but the outlook remains very cautious with rental value growth remaining persistently weak over the five year view.

Total return forecasts for the City and West End office sub-sectors have strengthened on the back of improved capital value growth expectations.

- The City and West End office submarket forecasts remain strong although rental value growth figures have been revised downwards for 2010 and 2011.
- Capital value growth is expected to be substantially weaker for these markets in 2011 but to remain positive which sets them apart from all other sectors.
- The consensus total return forecasts have strengthened for 2010 and largely stabilised for 2011, 2012 and the five-year view with returns for both subsectors expected to remain strong.

1 Source: HM Treasury Forecasts for the UK Economy 17 November 2010

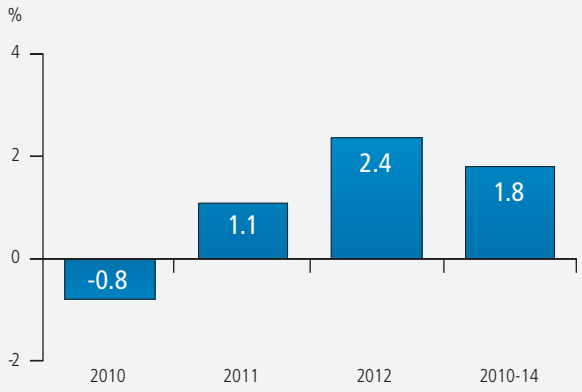
2 Source: ONS

3 Source: ONS

Across the sectors rental value growth remains weak, particularly for retail.

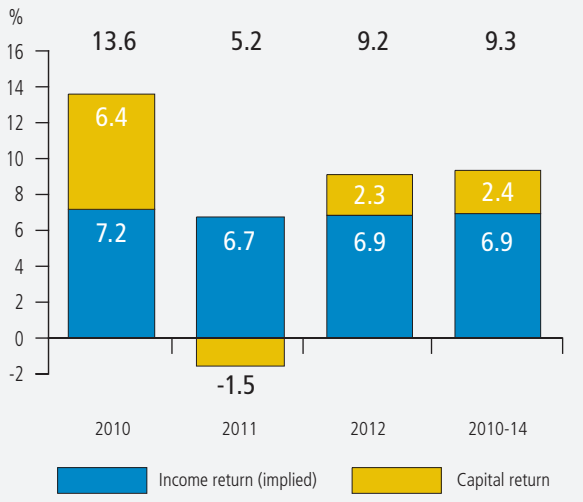
- The retail sectors are expected to show very weak performance in 2011 with falling capital value growth forecasts in each sector and only retail warehousing forecast positive rental value growth.
- Rental value growth is forecast to be marginally positive for all sectors in 2012 but again the consensus figures have moved downwards.
- Over the five year view the forecasts for standard shops remain the weakest.

Figure 1: All Property rental value growth forecasts



The consensus all property rental value growth forecast has strengthened this quarter. However the graph reveals how weak the rental value growth prospects are for property over the next few years. This pessimism perhaps reflects uncertainty over leasing structures as well as limited occupier demand for space. Falling lease lengths and the prevalence of break options are both likely to put downward pressure on rental value growth in a weak market.

Figure 2: All Property total return forecasts



The All Property total return forecasts have not changed significantly this time. The anticipated lack of investor appetite or buying power for property in 2011 is very clearly illustrated in the sharp decline in expected capital return. However income return is expected to remain stable for the next three years and the five year view generating above inflation total returns at the all property level.

Figure 3: Property derivatives pricing curve

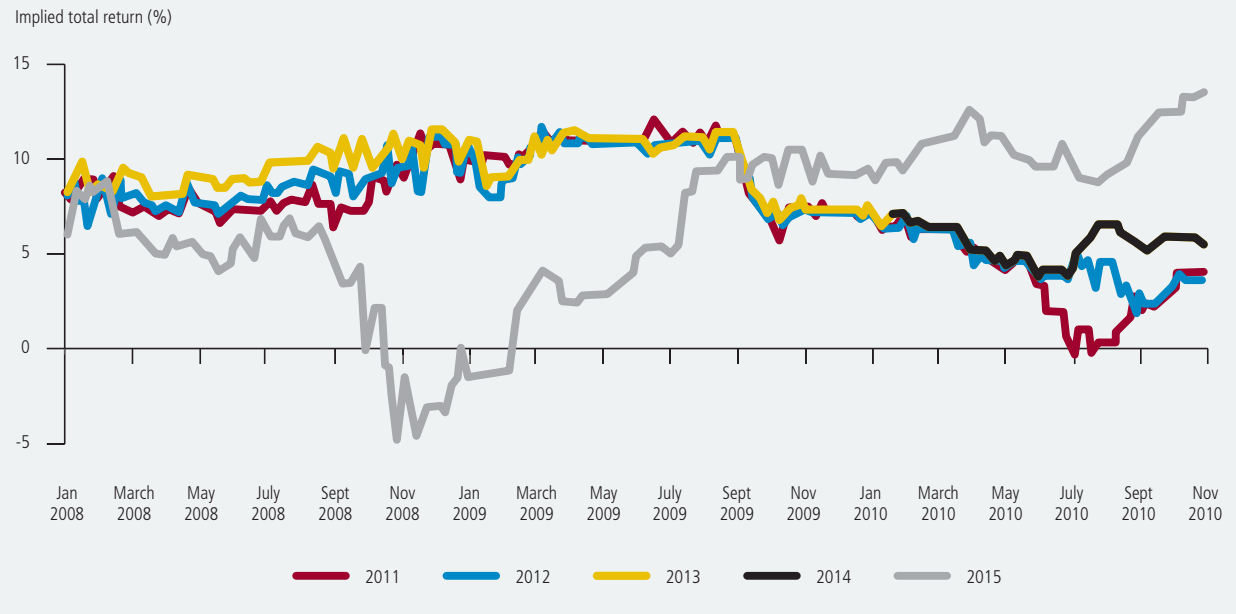


Figure 4: Property advisors and research consultancies (12 contributors)

	Rental value growth %						Capital value growth %						Total return %					
	2010		2011		2012		2010		2011		2012		2010		2011		2012	
Maximum	0.0	(0.0)	1.9	(3.1)	4.3	(4.8)	7.8	(9.0)	3.5	(5.0)	5.6	(6.4)	15.1	(17.0)	10.3	(12.2)	12.6	(14.3)
Minimum	-1.1	(-3.7)	-0.7	(-0.1)	1.1	(1.1)	6.1	(3.3)	-4.4	(-3.0)	0.0	(0.2)	13.6	(10.0)	1.9	(3.9)	6.5	(6.5)
Range	1.1	(3.7)	2.6	(3.2)	3.2	(3.7)	1.7	(5.7)	7.9	(8.0)	5.6	(6.2)	1.5	(7.0)	8.4	(8.3)	6.1	(7.8)
Median	-1.0	(-0.9)	1.0	(1.2)	2.1	(2.2)	7.0	(6.4)	0.3	(0.3)	1.2	(1.5)	14.0	(13.5)	6.5	(7.0)	8.1	(8.5)
Mean	-0.8	(-0.9)	0.9	(1.3)	2.2	(2.5)	6.9	(6.3)	-0.1	(0.4)	1.9	(2.2)	14.1	(13.7)	6.5	(7.1)	8.5	(9.1)

Figure 5: Fund managers (16 contributors)

	Rental value growth %						Capital value growth %						Total return %					
	2010		2011		2012		2010		2011		2012		2010		2011		2012	
Maximum	-0.3	(0.0)	3.6	(3.5)	3.5	(3.7)	9.8	(8.4)	2.8	(2.9)	5.4	(4.5)	16.7	(15.3)	9.0	(10.2)	11.8	(11.7)
Minimum	-1.8	(-2.9)	-0.1	(-0.7)	1.1	(1.1)	2.5	(1.9)	-9.4	(-7.8)	-1.6	(-2.0)	9.7	(9.3)	-2.4	(-0.9)	5.7	(5.5)
Range	1.5	(2.9)	3.7	(4.2)	2.4	(2.6)	7.3	(6.5)	12.2	(10.7)	7.0	(6.5)	7.0	(6.0)	11.4	(11.1)	6.1	(6.2)
Median	-0.9	(-1.1)	1.0	(1.0)	2.5	(2.5)	6.4	(6.2)	-1.2	(-1.8)	2.1	(2.2)	13.7	(12.9)	5.5	(4.7)	9.6	(8.9)
Mean	-0.9	(-1.3)	1.2	(1.1)	2.3	(2.4)	5.9	(5.6)	-2.8	(-2.2)	2.4	(2.2)	13.2	(12.7)	4.0	(4.6)	9.5	(9.1)

Figure 6: All forecasters (29 contributors)

	Rental value growth %						Capital value growth %						Total return %					
	2009		2010		2011		2009		2010		2011		2009		2010		2011	
Maximum	0.0	(0.0)	3.6	(3.5)	4.3	(4.8)	9.8	(9.0)	3.5	(5.0)	5.6	(6.4)	16.7	(17.0)	10.3	(12.2)	12.6	(14.3)
Minimum	-1.8	(-3.7)	-0.7	(-0.7)	1.1	(1.1)	2.5	(1.9)	-9.4	(-7.8)	-1.6	(-2.0)	9.7	(9.3)	-2.4	(-0.9)	5.7	(5.5)
Range	1.8	(3.7)	4.3	(4.2)	3.2	(3.7)	7.3	(7.1)	12.9	(12.8)	7.2	(8.4)	7.0	(7.7)	12.7	(13.1)	6.9	(8.8)
Std. Dev.	0.5	(0.9)	0.9	(0.9)	0.8	(0.9)	1.5	(1.8)	3.2	(2.8)	1.8	(1.7)	1.4	(1.9)	3.2	(2.8)	1.9	(1.8)
Median	-0.9	(-1.0)	1.0	(1.2)	2.2	(2.4)	6.8	(6.2)	-0.6	(-0.5)	2.0	(2.1)	14.0	(13.3)	5.9	(6.2)	9.0	(8.8)
Mean	-0.8	(-1.1)	1.1	(1.2)	2.4	(2.5)	6.4	(5.9)	-1.5	(-1.0)	2.3	(2.2)	13.6	(13.2)	5.2	(5.7)	9.2	(9.1)

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	1.5	3.4	4.7	3.7	8.3	0.3	3.3	3.3	15.6	7.0	10.1	10.1
Industrial	-1.5	-0.3	0.9	0.5	2.8	-3.0	1.4	1.0	10.7	4.6	9.4	8.8
Standard shops	-2.4	-0.7	0.8	0.7	5.8	-2.8	1.4	2.0	12.2	3.1	7.6	8.1
Shopping centres	-3.5	-0.5	0.9	0.5	6.4	-2.8	1.5	2.1	13.7	4.0	8.5	9.2
Retail warehouse	-1.0	0.7	1.8	1.5	7.2	-1.8	2.5	2.8	14.1	4.7	9.0	9.2
All Property	**-0.8**	**1.1**	**2.4**	**1.8**	**6.4**	**-1.5**	**2.3**	**2.4**	**13.6**	**5.2**	**9.2**	**9.4**

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.

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Property advisors (includes research consultancies): BNP Paribas Real Estate, Capital Economics, CBRE, Colliers CRE, Cushman and Wakefield, DTZ, Fletcher King, GVA Grimley, JLL, King Sturge, Paul Mitchell Real Estate Consultancy, Real Estate Forecasting Limited.

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

Equity Brokers: One that does not wish to be named.

European Consensus Forecasts
November 2010

Louise Ellison,
Research
Director,
Investment
Property Forum

Key Points

- The consensus for 2010 has improved but expectations for rental value growth remain very weak with just 12 of the 28 cities forecast positive rental value growth by year end.
- London City and West End remain expected to outperform all the other cities reported by a significant margin in 2010.
- Moscow is the biggest improver for 2010 and is now ranked third of the 28 cities reported.
- The consensus forecasts for 2011 have been revised downwards for 9 of the cities. Positive rental value growth is expected in 23 but Lisbon has now joined Dublin, Madrid and Barcelona with negative consensus rental value growth forecast for 2011.
- The consensus forecasts for 2012 have been revised downwards but remain positive for all markets reported.
- Moscow is expected to outperform both London sub markets in 2012.
- London City and West End markets remain forecast the strongest rental value growth for the full three year and five year views.
- The level of expected rental growth remains weak and overall the consensus forecasts depict a slow recovery in rental income levels across Europe.

Outlook for 2010 improves

The IPF European Consensus Forecast once again show strengthening expectations for the London City and West End office markets which remain ranked first and second of the 28 cities reported. The forecast for Moscow has improved most sharply in this round of the survey moving up 19 places to rank in third place behind the two London sub markets. The forecasts for a number of the European cities monitored have improved with 12 of the 28 now forecast positive rental value growth figures for this year. This is an improvement on the May forecasts where just 4 cities were forecast positive figures. In addition to the improved outlook for London and Moscow forecasts for Oslo, Stockholm and Brussels have been revised upwards. These cities are now expected to show better rental growth performance than the two Paris districts forecast by the end of the year.

Unsurprisingly of the cities reported, those forecast the weakest performance remain the same – Madrid, Barcelona and Dublin. One point to note is the downward revision of the forecast for Frankfurt. This was one of only three cities where the consensus forecast for 2010 has fallen in this round of the survey.

Continued strong performance expected for Moscow in 2011

The graph for 2011 illustrates the sharp changes in the rental value growth expectations for these cities over the last two years. In this instance the stand out feature is the forecast for Moscow which has moved up very sharply this time from 3.7% to 7.4%. The London forecasts by contrast have dropped back a little this time although they remain the most positive of the consensus views. The French cities covered have also moved up this time, particularly Lyon which has moved from a marginally negative forecast in the last survey to +2% in this round. The consensus rental value growth forecasts for the Paris CBD and La Defense have also moved upwards this time and all are showing positive figures 2011.

Overall the forecasts for 2011 are marginally more positive in this round of the survey than they were six months ago. However there are clearly predictable exceptions. The consensus is for Dublin, Barcelona, Madrid and Lisbon to experience further falls in rental value growth in 2011. These cities are joined in this round of the survey by Hamburg where the mean rental value growth forecast has been revised downwards this time from 0.7% to just below zero.

Figures for 2012 and the three- and five-year forecasts show a slow recovery

The consensus forecasts for 2012 have been revised downwards for 17 of the 28 cities, although Moscow stands out as having bucked this trend. The City and West End of London remain expected to perform strongly in terms of rental value growth but the consensus has been revised downwards for both with the City of London showing the sharpest adjustment. This possibly reflects an expected upturn in new stock coming to market. A sharp downward adjustment can also be seen in the Paris CBD consensus forecast.

The three year forecasts are largely improved on those reported in May 2010 but remain weak. Four cities have negative consensus forecasts of returns over 3 years and for a further 4 the consensus is for returns to be less than 1%. The two London submarkets remain forecast to outperform all the other cities covered by some margin, although Moscow is close behind in third place this time.

The five year forecast is marginally stronger with a positive consensus forecast generated for all cities. Barcelona, Madrid and Lisbon retain weak consensus forecasts over the five year view whereas Dublin, in contrast shows an improvement this time. There is clearly some expectation that economic recovery or support will drive stronger occupier demand here over the medium term. This view may be revised in light of current pressures on the Irish banking system.

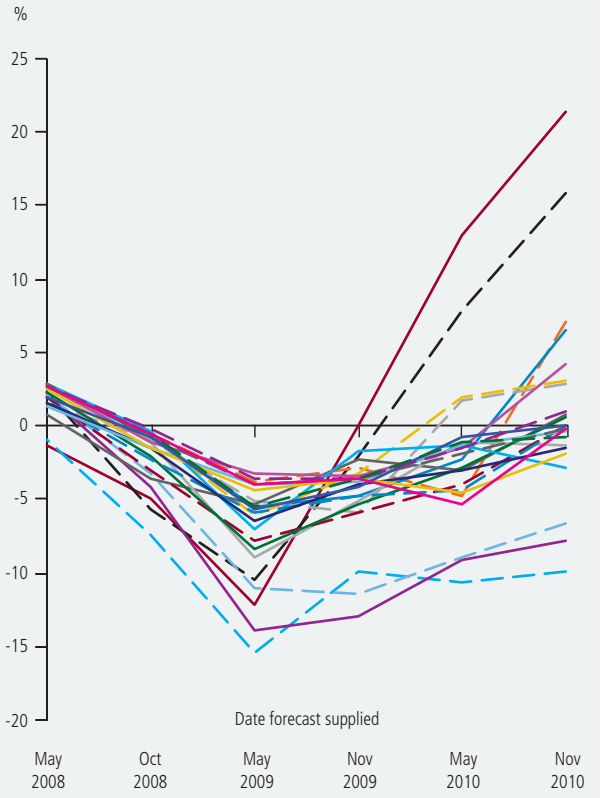
Summary

The November 2010 IPF European Consensus Forecast shows any recovery in rental value growth is expected to be weak and slow in the majority of the cities covered. Whilst the City of London and West End markets are expected to enjoy stronger performance, these are the only markets where the consensus is for rental value growth to be in double digits over three years.

Figure 1: European office mean rental value growth forecasts, November 2010

	Year rental growth forecast % pa			3-year forecast 2010-12 % pa	5-year forecast 2010-14 % pa
	2010	2011	2012		
Vienna	-1.5	1.1	2.5	0.7	1.9
Brussels	4.2	1.0	2.3	2.5	3.1
Prague	-0.2	1.1	3.3	1.4	2.5
Copenhagen	-0.5	0.9	2.2	0.8	1.5
Helsinki	0.9	1.0	2.9	1.6	2.4
Lyon	-0.1	2.3	3.5	1.9	2.6
Paris CBD	3.0	3.3	4.6	3.6	4.6
Paris la Defense	-1.3	3.4	4.6	2.2	3.6
Berlin	-0.1	1.8	2.6	1.4	2.2
Frankfurt	-2.9	1.9	4.1	1.0	2.0
Hamburg	-3.1	-0.1	2.8	-0.1	1.5
Munich	-0.9	1.6	2.8	1.2	2.2
Athens	na	na	na	na	na
Budapest	0.0	1.6	2.4	1.3	2.2
Dublin	-6.7	-1.0	4.7	-1.1	3.0
Milan	-0.2	1.4	2.5	1.3	2.8
Rome	0.5	1.2	1.4	1.1	1.9
Luxembourg	0.4	1.3	1.8	1.2	2.4
Amsterdam	-0.3	0.8	2.1	0.9	2.4
Oslo	4.3	3.0	3.4	3.6	3.4
Warsaw	2.9	3.2	4.7	3.6	3.5
Lisbon	-1.9	-0.3	1.0	-0.4	1.0
Moscow	7.0	7.4	9.8	8.1	8.0
Madrid	-10.0	-1.9	1.9	-3.5	1.1
Barcelona	-7.9	-1.2	2.7	-2.2	0.9
Stockholm	6.5	3.7	4.3	4.8	4.4
Zurich	na	na	na	na	na
London: City	21.2	8.3	8.3	12.4	9.0
London: West End	15.7	7.7	8.2	10.5	8.3
Manchester	0.7	0.9	2.7	1.4	1.9

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

Forecast Contributors: The IPF would like to thank the following organisations for contributing data to the November 2010 European Consensus Forecast: Aberdeen Property Investors, Alecta, Aviva Fund Management, Cushman & Wakefield, DTZ, Grosvenor, Invesco, JLL, 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 3: Forecasts for year 2011

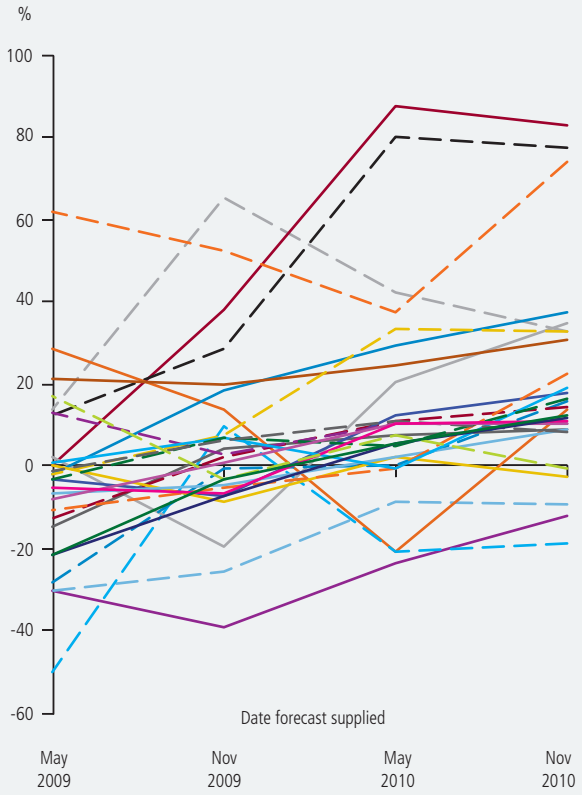
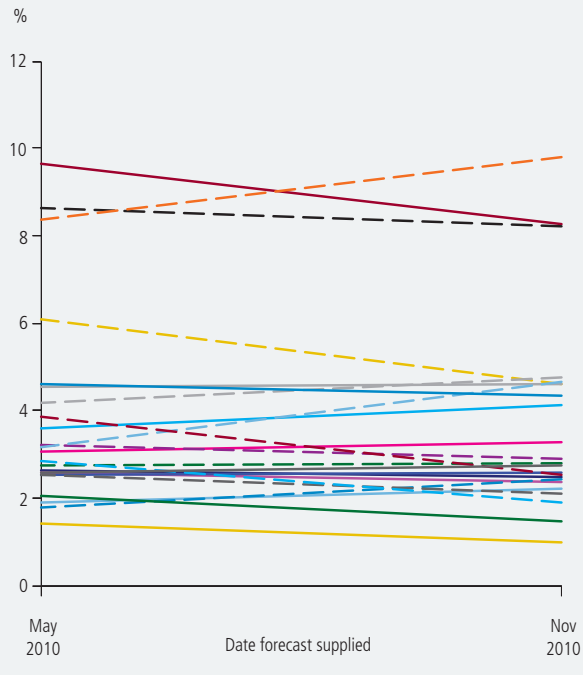


Figure 4: Forecasts for year 2012



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 30 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. Figures are only reported for cities where a minimum of 4 contributions were received.

The definition of market rent used in the survey is "achievable prime rental values for city centre offices, based on buildings of representative size with representative lease terms for modern structures in the best location." Prime in this case does not mean headline rents taken from individual buildings, but rather rental levels based on market evidence, which can be replicated. All figures included in the survey are required to have been generated by formal forecasting models. The report is based on contributions from 13 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

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

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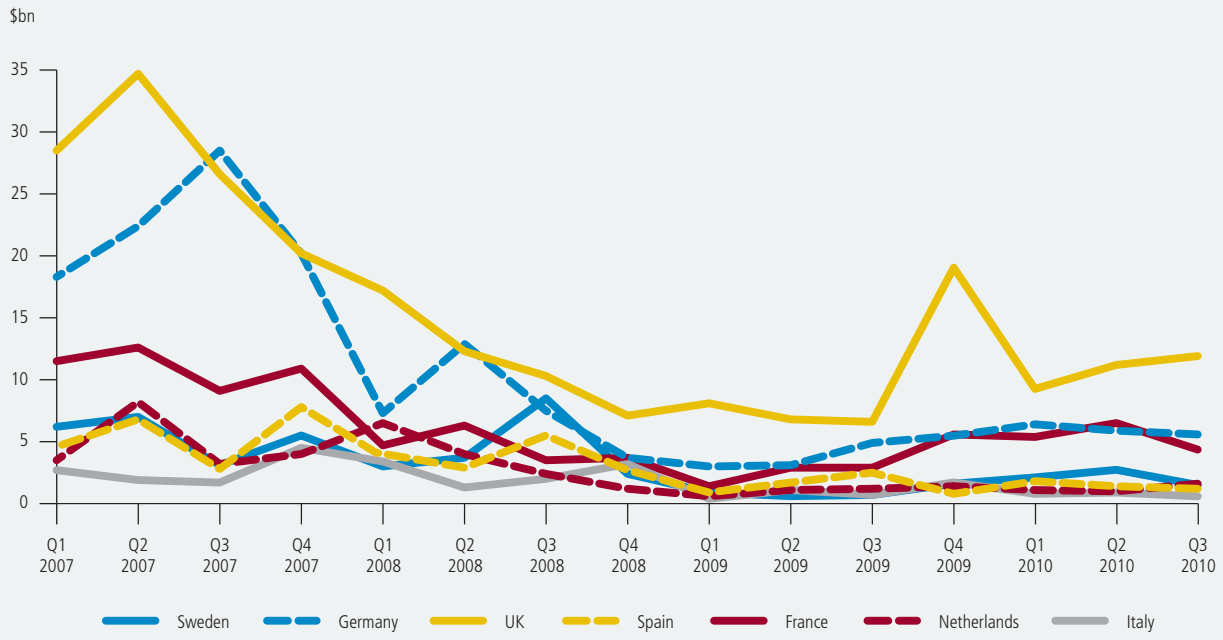
European sales volumes

The data below has been provided by Real Capital Analytics (RCA), which tracks commercial property transactions in more than 80 countries worldwide. RCA focuses primarily on the main income-producing property types: office, industrial, retail, apartment and hotel, plus sales of commercially developable land sites.

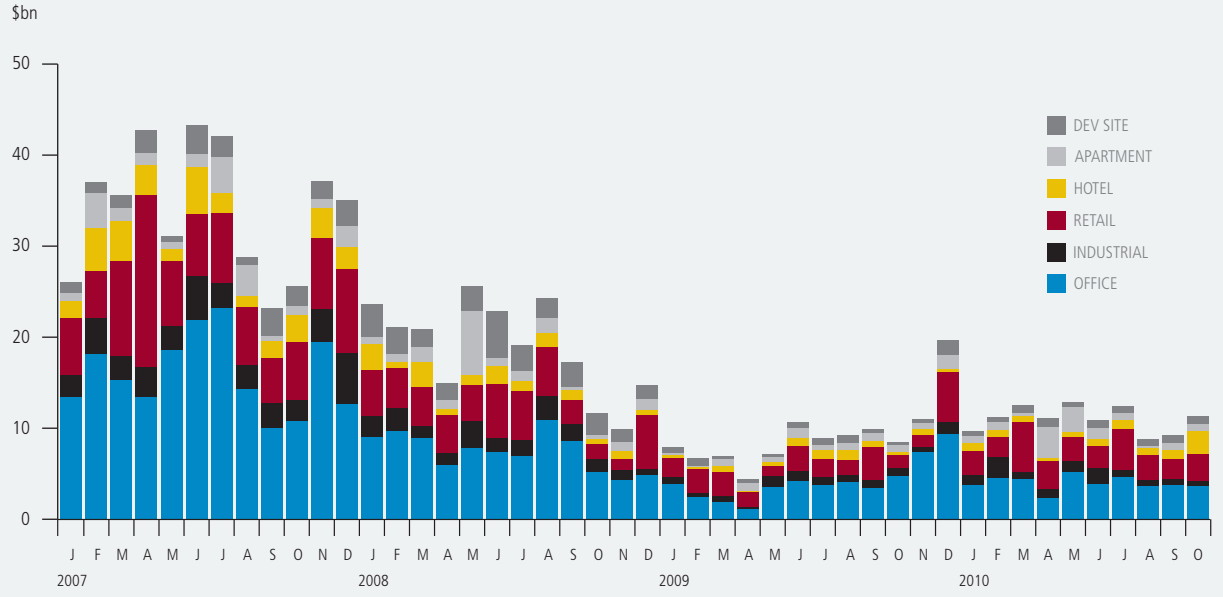
Figure 1: European transactions by country



Source: Real Capital Analytics, Inc 2010. For more current deals, cap. rates and property details visit www.rcanalytics.com

Note: Based on independent reports of properties and portfolios of $10m and greater. Data is believed to be accurate, but not guaranteed.

Figure 2: European transaction volumes by property sector



Source: Real Capital Analytics, Inc. 2010. For more current deals, cap rates and property details visit www.rcanalytics.com

Forum activities and announcements

Executive team

Barbara Hobbs has joined the IPF to cover Suleen's maternity leave which begins in December. Barbara is also looking after the Annual Lunch in January.

She can be contacted on **020 7194 7924** or **bhobbs@ipf.org.uk**

Midlands Dinner

The Midlands Dinner, celebrating 10 years of the IPF in the Midlands, took place on 14 October at the ICC in Birmingham. 500 property people filled the room, and were entertained by **Gerald Ratner**, the after dinner speaker.

Guest speaker, Gerald Ratner, addressing members and guests

IPF Midlands Dinner

Gerald Ratner, Simon Robinson, John Gellatly

Investment Education Programme (IEP)

The Investment Education Programme 2010/11 cycle is in full swing. The next module will be Property Investment Appraisal, taking place on 17-19 January 2011. Further information can be found on the IPF website.

If you are interested in enrolling on the 2011/12 IEP cycle, please visit the IPF website, or contact Frankie Clay on 020 7194 7928.

The IPF Educational Trust has agreed to fund the re-development of the new online module providing an introduction to property as an asset class, which will be launched in March/April 2011.

IPF Annual Lunch 2011

Our Guest Speaker is David Smith, Economics Editor of The Sunday Times.

Date: Friday 28 January 2011

Time: 12 noon for 12.30pm

Venue: Hilton Park Lane, London W1

Dress Code: Lounge Suit

Ticket Price: £105 +VAT per person (excluding wine and liqueurs)

Tables of 10 and 12 are available. Tickets may also be purchased individually.

For more information and to book please contact: **Barbara Hobbs**, bhobbs@ipf.org.uk

This event is kindly sponsored by Chase & Partners, Langham Hall and VALAD.

Should you be interested in taking an advert in the Lunch booklet, please contact **Sue Forster**, email: sforster@ipf.org.uk.

Future dates for your diary

Midlands Annual Lunch
Friday 6 May 2011, The Hyatt Regency, Birmingham

Annual Dinner 2011
Wednesday 22 June 2011, The Grosvenor, Park Lane, London

IPF Investment Property Forum

UNIVERSITY OF CAMBRIDGE
Professional Studies

Investment Education Programme

Invest in your future

The IPF programme, run by the University of Cambridge Institute of Continuing Education, was established to provide the opportunity for busy professionals to study property investment and finance. Since its launch in 1999, over 500 individuals, from a wide variety of organisations, have participated with more than 150 completing the seven full modules and gaining an IPF Diploma.

The programme modules are:

- Investment Valuation & Portfolio Theory
- Financial Instruments & Investment Markets
- Property Investment Appraisal
- Property Finance & Funding
- Indirect Property Investment
- International Property Investment
- Portfolio Management

Applications are being accepted for the 5 remaining modules in the 2010/11 cycle.

Dates for the 2011/12 Investment Education Programme cycle will be released in the new year.

For more information or to discuss your professional development requirements, please contact the Institute of Continuing Education:

Tel: +44 1223 760860

Email: profstudies@ice.cam.ac.uk

Website: **www.ice.cam.ac.uk**

IPF Investment Property Forum

Annual Lunch 2011

Friday 28 January

Venue: **The Hilton Park Lane, London W1**

12:00 for 12:30 | Lounge Suit

Guest Speaker: David Smith

Economics Editor of The Sunday Times

Ticket price: £105 + VAT

£123.38 inclusive of VAT @ 17.5% per person
From 4 January, £126.00 inclusive of VAT @ 20% per person

The Ticket Price excludes wine and other beverages.

Please reserve tables for the Annual Lunch by completing a booking form and returning it with payment, as soon as possible. Tables will be for 10 or 12 (limited availability of larger tables). Individual bookings can be made and, in this case, please indicate if you wish to join a table with specific people.

Please note that wine orders, hosted bars and special dietary requirements must be arranged directly with the Hilton Park Lane, contact details will be supplied on confirmation of your booking, together with your tickets.

To book a table, please contact Barbara Hobbs:
bhobbs@ipf.org.uk

This event is kindly sponsored by:

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