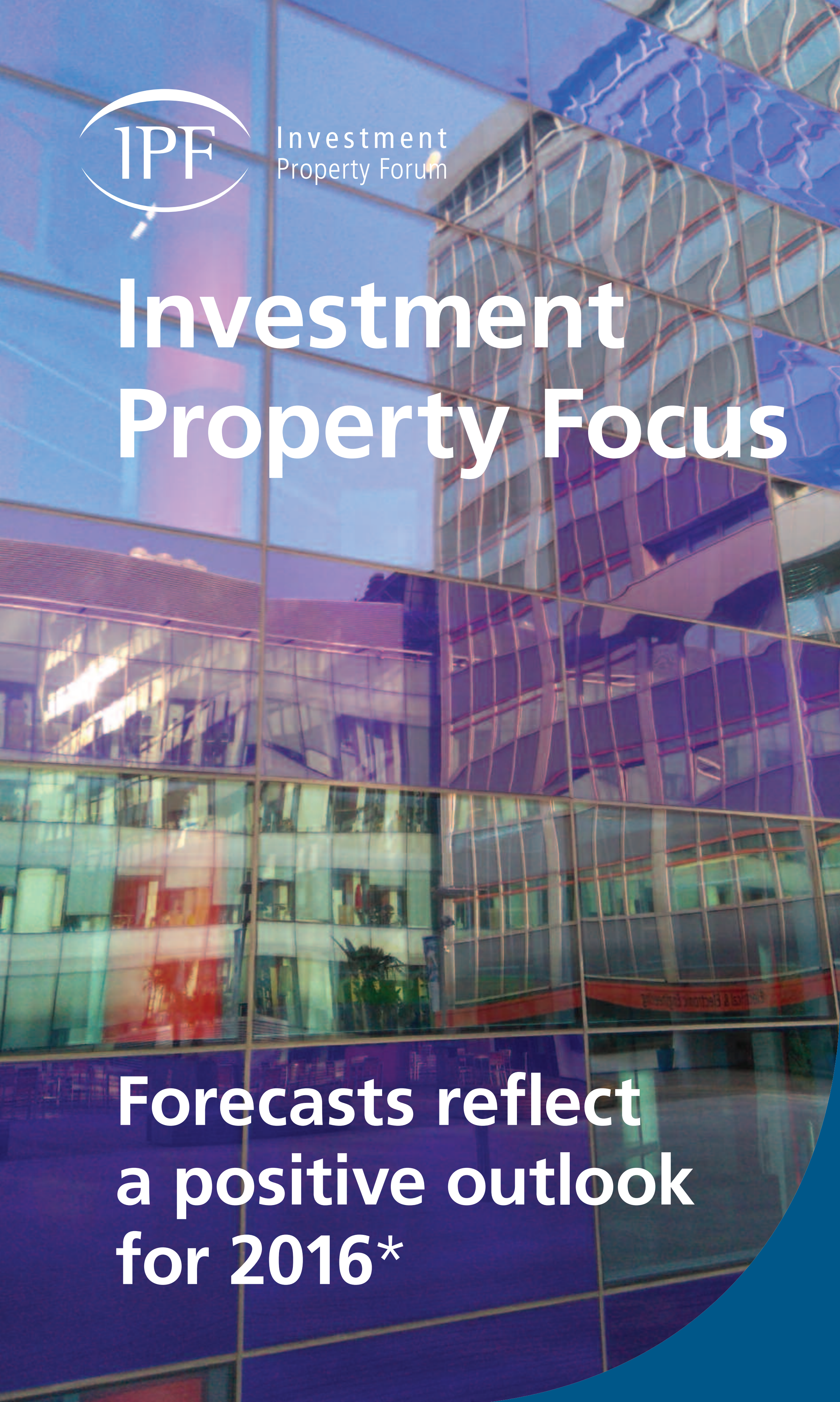

Investment Property Forum

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Investment Property Focus

Forecasts reflect a positive outlook for 2016*

* IPF UK Consensus Forecasts, November 2015

IPF Research Programme 2015-2018

The IPF Research Programme is 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 22 research sponsors. We are very grateful to this group of companies for their support of the 2015-2018 Programme.

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Welcome to the December 2015 edition of Investment Property Focus.

We are delighted to include a synopsis of the paper by **Pat McAllister** and **Anupam Nanda** of Henley Business School University of Reading that was awarded the fourth annual Nick Tyrrell Research Prize in September. The Prize, which is sponsored by INREV, IPF and the Society of Property Researchers, attracted 36 entries this year from across the globe. The winning paper, 'Do foreign buyers compress office cap rates?' establishes a significant negative effect between the activity of foreign investors and observable levels of capitalisation rates in 28 major European office markets.

Full details on submitting a paper for next year's Prize are included on page 48.

Recognising the increasing number of international and domestic investors who are making co-investment commitments alongside their allocations to discretionary funds, the IPF organised a panel discussion in October, chaired by **Justin Cornelius** of Berwin Leighton Paisner to explore the implications of this trend. The overview of the panel discussion between **John Harding** of BlackRock, **Damien Smith** of The Townsend Group and **Rob West** of Clearbell Capital makes for interesting reading.

As everyone is aware, the rise in multichannel shopping has fundamentally changed the retail industry. However, the contribution of physical stores to overall retailer performance in this new environment is less understood. The IPF Research Programme commissioned **Martin Summerscales** and **Matt Thompson** of CBRE to investigate the extent to which physical stores add value to retailers, beyond their traditional role as 'transaction space'. Their conclusions are summarised on page 11 onwards.

The findings from a number of other IPF Research Programme projects are featured in this edition of Focus. These include a one-page 'At a Glance' summary of the 2015 survey of institutional investors as to their attitude towards the residential sector. The survey found that more than half of existing investors planned to increase their investment over the next 12 months. Another IPF survey updated this year was 'Outlook for Development Finance in the UK', first published in 2011. **Kate Gimblett**, who undertook the 2015 study, found that there has been a notable increase in the availability of development finance over the last four years from long-standing lenders and a growing phalanx of new entrants. **Paul Mitchell's** research on individual property risk, published by the Programme this summer, identified a number of key considerations for investors, not least that investors should be concerned more with structuring property portfolios on the basis of exposure to lease events and the need for intensive active management than on the traditional basis of geography because these issues make a bigger difference to a property's performance and risk profile.

Amanda Howard of Nabarro has kindly updated the IPF legal and regulatory round-up, providing a comprehensive overview of key recent and upcoming legal developments affecting UK property investment as regards tax, general UK property law, energy and environment, planning and development, financial regulation, investment fund vehicles, IT, finance, residential ownership and insolvency. The implications of the new GAAP regime are also outlined by **Avni Mashru** and **Sandra Dowling** of PwC.

The November IPF UK Consensus Forecasts and European Rental Consensus Forecasts are also included in this edition, together with the round-up of the Forum's activities and announcements.

Lastly, don't forget to book your ticket/table for the Annual Lunch on 29 January – I look forward to seeing you there.

Sue Forster
Chief Executive, IPF

Do foreign buyers compress office cap rates?

PAT MCALLISTER & ANUPAM NANDA
Henley Business School, University of Reading

This article is a summary of the authors' paper, 'Do Foreign Buyers Compress Office Real Estate Cap Rates?', which was awarded the fourth annual Nick Tyrrell Research Prize[1] in September 2015. The paper establishes a significant negative effect between the activity of foreign investors and observable levels of capitalisation rates in 28 major European office markets.

Background

The growth of cross-border real estate investment in recent decades has generated increasing interest about its characteristics and impacts. An important market shift has been the global transformation in the range and scope of real estate investment organisations and their third party service providers. In addition to fairly long-established institutional investors, sovereign wealth funds, specialist open and closed end real estate funds, investment banks, specialist real estate investment managers, private equity groups and endowment funds have emerged as significant market participants, with a number of these organisations creating global operational platforms to execute international real estate investment strategies.

Although there is little empirical evidence, foreign investors are perceived to be affecting prices. This research seeks to isolate the effect of foreign capital flows on capitalisation rates.

Data

The analysis used data from DTZ's – now Cushman & Wakefield – Investment Transaction Database (ITD), specifically the prime yields series for 28 major European office markets as there is limited reporting on actual transaction yields, especially in the Continental European markets. The focus of the paper is on major office markets, using a dataset of 9,126 office sales in 28 European cities in 15 countries between 1999 and 2013, with a total value of €380bn. The average transaction value was circa €40m.

The ITD defines a purchaser as foreign if the purchaser's source of capital or location does not stem from the same country where the property is located. Foreign capital is then split between intra-regional (investing in home region, but not home market e.g. UK investor in Germany, or German in Poland) and inter-regional (non-European investor, so Asian or US money for example in Europe). It should be noted that the notion of foreignness is becoming increasingly problematic in this context, not least because many of the real estate investing institutions located in global financial centres will not be the ultimate investors in the sense that they are not the source of the capital, global investors may have multiple headquarter locations and foreign investing organisations who set up local operating platforms are likely to have access to similar informational sets about markets as the local investors.

1 The Nick Tyrrell Research Prize was established in 2011 by INREV, IPF and SPR to acknowledge innovative and high quality, applied research in real estate investment. The Prize is in memory of the work and industry contribution of Nick Tyrrell, who passed away in August 2010. Nick Tyrrell was Head of Research and Strategy and a Managing Director in J.P. Morgan Asset Management's European real estate division. His research work was characterised by a combination of academic rigour and practical relevance. For further details, please contact Henri Vuong, Director of Research and Market Information at INREV: henri.vuong@inrev.org.

It is important to bear in mind a number of points about the data. Due to a range of interrelated attributes of real estate investment markets – thin trading, large lots, illiquidity etc., the term 'flow' is a perhaps misleading analogy to describe patterns of investment. Since foreign investors tend to buy larger lots, their activity tends to be more sporadic, lumpy and uneven than investment by local investors.

There is also a timing issue associated with reported transactions. Although the decision to commit funds may have taken place much earlier, flows tend to be recorded when legal completion of a transaction occurs.

Results

SALIENT DATA FEATURES

The sample period is dominated by the period of stable real estate capitalisation rates between 2000 and 2004. Rates fells dramatically between 2005 and 2007 in the market boom preceding the Global Financial Crisis (GFC), during which they then rose significantly, peaking in 2009. However, cities within Europe had very different trajectories in the sample period. Munich, Paris and London (West End) had the lowest

Figure 1: **Office market transactions – summary data**

City	Cap rate	Transaction volume	Foreign	National real risk free rate	Availability ratio	Country liquidity ratio	Country risk factor	Period
	%	€m pa	%	%	%	%	%	
Amsterdam	6.3	647	63	1.50	7.07	4.01	-0.42	1999-2013
Antwerp	7.28	61	30	1.81	11.52	5.83	-0.11	1999-2013
Barcelona	5.60	344	40	1.74	7.45	2.82	0.41	2000-2013
Berlin	5.24	369	29	1.88	8.71	4.45	-0.63	2000-2013
Birmingham	6.18	120	42	1.73	7.29	8.48	-0.13	1999-2013
Brussels	6.28	734	62	1.81	9.78	5.83	-0.11	1999-2013
Bucharest	8.66	58	99	-0.32	5.94	1.55	3.24	2006-2013
Budapest	7.91	155	79	1.74	17.75	2.48	3.31	1999-2013
Copenhagen	5.55	174	16	1.49	6.21	3.17	-0.45	2000-2013
Dublin	5.58	236	7	2.40	16.03	2.88	0.82	2000-2013
Dusseldorf	5.33	252	28	1.88	9.66	4.45	-0.63	2000-2013
Frankfurt	5.30	739	31	1.88	11.92	4.45	-0.63	1999-2013
Glasgow	6.16	236	39	1.73	6.11	8.48	-0.13	1999-2013
Gothenburg	5.83	74	33	2.28	9.78	8.88	-0.42	2000-2013
Hamburg	5.52	293	19	1.88	6.30	4.45	-0.63	2000-2013
Helsinki	6.07	57	48	1.80	3.78	2.92	-0.41	2000-2013
Leeds	6.29	164	26	1.73	4.44	8.48	-0.13	1999-2013
London	4.95	13,487	50	1.73	6.74	8.48	-0.13	1999-2013
Madrid	5.49	945	35	1.74	7.07	2.82	0.41	1999-2013
Manchester	6.20	299	26	1.73	10.88	8.48	-0.13	1999-2013
Marseilles	7.39	72	34	2.11	n/a	4.23	-0.32	2000-2013
Milan	5.81	591	34	2.34	5.52	2.93	0.48	1999-2013
Munich	4.85	389	24	1.88	7.47	4.45	-0.63	2000-2013
Paris	5.12	2,774	60	2.11	4.03	4.23	-0.32	1999-2013
Prague	7.46	314	82	1.40	11.22	4.46	0.01	1999-2013
Sheffield	7.07	43	12	1.73	n/a	8.48	-0.13	1999-2013
Stockholm	5.35	667	26	2.28	10.57	8.88	-0.42	2000-2013
Warsaw	7.73	422	94	2.58	9.89	4.52	2.01	1999-2013

capitalisation rates. The German cities had low capitalisation rates and remained relatively stable, in contrast to the four central and eastern European (CEE) cities which had high capitalisation rates and high volatility. The Republic of Ireland and Spain experienced an even more extreme boom-bust cycle.

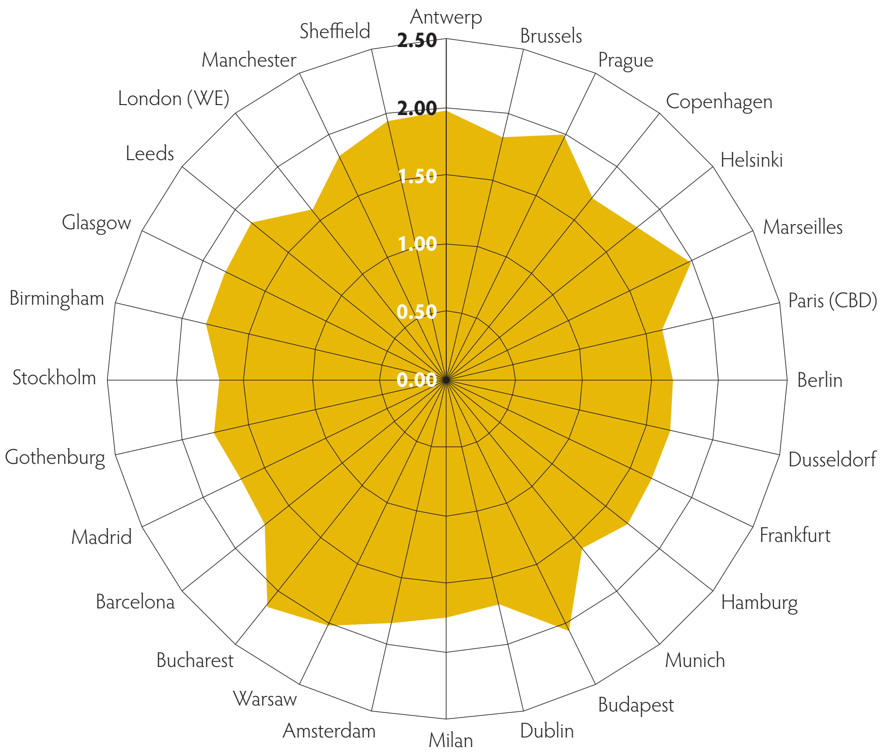
Turning to capital flows, a notable feature of the data is that London alone accounted for over half of all transactions by value. Its transaction volumes were nearly five times greater than the next largest destination – Paris. It is difficult to assess the extent to which this discrepancy is a data measurement issue or reflects accurately the relative attractions of London to real estate investors as a leading global city with a highly open and transparent real estate investment market.

Whilst London was the largest centre for foreign real estate investment in absolute terms, it was not the largest in relative terms (see Figure 1). In line with high levels of foreign penetration in major economic sectors, cities in the transition economies of CEE had the highest proportion of foreign relative to domestic investment, e.g. foreign investors accounted for 94% of transaction volumes in Warsaw. In the EU15 countries, foreign investors accounted for more than half of total investment in Amsterdam (63%), Brussels (62%) and Paris (60%). In London, the comparable figure was just under 50%. It is notable that the German cities which tended to have low capitalisation rates also tended to have relatively low levels of foreign real estate investment. For instance, foreign investors in Munich (which had the lowest mean capitalisation rate in the sample period) accounted for only 24% of transaction volumes. However, foreign investment was particularly low in Dublin – perhaps because foreign investors considered it to be too expensive during its boom period and too risky during the subsequent severe downturn.

STANDARD CAP RATE MODELLING

The diversity of market circumstances reinforces the importance of controlling for confounding variables to isolate and estimate the effect of levels of foreign investment on the capitalisation rates, the variation in which is shown in Figure 2. Using the model developed by Chervachidze and Wheaton (CW), the authors considered the determinants of these rates. The residual variation from this model then provided an estimate of the unexplained variance in capitalisation rates that may be caused by other confounding factors e.g. market transparency, size, foreign investment, position in global urban economic hierarchy etc.

Figure 2: **Distribution of log (office cap rate)**



Both the real risk-free rate coefficient and the real rent ratio were statistically significant, the former positive and the latter negative, indicating that capitalisation rates are lower where real rents are above their long-term average. This finding is also in line with the results of the CW models in the US. It is consistent with adaptive expectations by investors. When the basic model is extended to include additional variables, the coefficients remain stable. Perhaps unsurprisingly, there is a statistically significant positive coefficient for country risk on capitalisation rates. All else equal, the level of bank lending in country has no significant effect on capitalisation rates. When the model is extended to include the proportion of foreign investment, there is a statistically significant negative effect. Other variables such as real estate market transparency, World City ranking (according to number of advanced producer services) and monetary and exchange rate variables are not significant.

SECOND STAGE ORTHOGONALIZED MODELS

Figure 3 illustrates the distribution of residual variation across all markets averaged over time. There are many markets, e.g. Bucharest, Budapest, Warsaw, Dublin, Paris and Prague with a significant residual variation left unexplained by the basic CW cap rate model. This led to the second stage modelling, which attempted to further explain the residual variation. All correlations between two variables greater than 25% were put through the orthogonalization process, so removing variables of common dependency – Figure 4 shows the impact of this 'cleansing'.

Figure 3: **Stage 1 cap rate residuals**

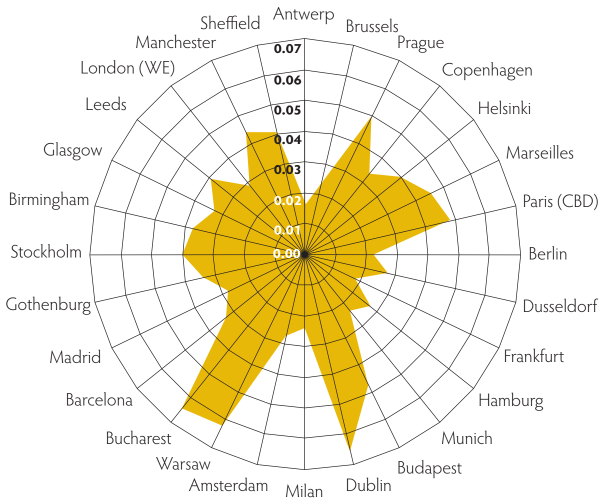
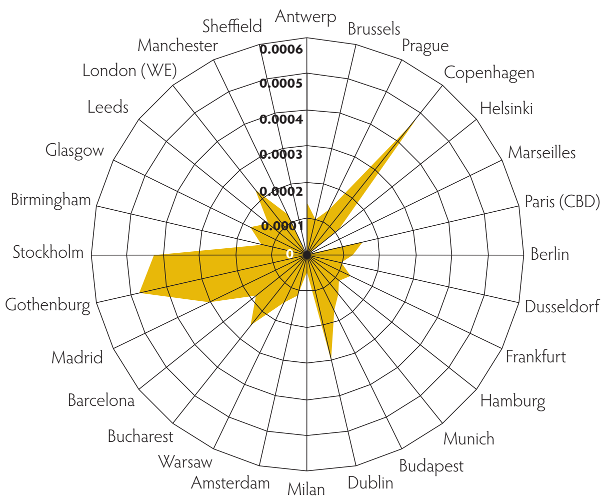


Figure 4: **Stage 2 cap rate residuals**



In all model specifications, the coefficient on the foreign investment variable was found to be statistically significant and negative. This supports the hypothesis of an increase in foreign investment producing compression of capitalisation rates. The results for the other confounding variables are broadly as expected. Moreover, a local market control of availability ratio is introduced). Where the number of advanced producer services (APS) was used as a basis for ranking cities as part of a global hierarchy, there was an expected negative effect of global city ranking on capitalisation rate. The size of coefficient of APS variable is substantially larger (0.208) than other controls such as foreign investment, market transparency and space availability. It suggests that the city's position in global urban economic hierarchy that is the most important determinant of differences in office cap rates.

ROBUSTNESS TESTS

Several alternative models and samples were tested to address some robustness concerns. All robustness tests indicated a very robust and statistically significant effect of the share of foreign investment on local cap rate.

"The research results predict a 30 basis points fall in cap rate following a 10 percentage point increase in foreign share of total investment."

Conclusions

There are substantial methodological challenges in isolating the effect of foreign investment on capitalisation rates. The key issue is that both foreign investment levels and capitalisation rates are likely to be jointly determined by interdependent variables such as real estate market maturity and transparency, economic vitality and market risk. This paper counteracts these problems by modelling the determinants of the variance in capitalisation rates that is not explained by 'standard' variables, such as risk free rates and rental growth expectations. When controls are introduced to confound for the expectation that cities with low capitalisation rates and high levels of foreign investment are likely to be in the mature real estate markets of economically dynamic global cities, the finding of a negative effect of foreign investment on capitalisation rates remains robust.

The most important implication of these results is on the pricing mechanism and forecasting of performance in local office markets. Anecdotal evidence suggests that foreign investors tend to invest in premium real estate locations and assets. City size, economic importance and real estate market liquidity and transparency, are affecting capitalisation rates and the level of foreign investment. Therefore, although, the transmission of demand from foreign investors to real estate prices is likely to be complex, the net effect on the cap rate is significant and it suggests that foreign presence should be factored into analysing local market dynamics as 'anchoring' domestic transactions to the price dynamics of foreign transactions may have a 'ratchet' effect.

The analysis also raises a few further questions:

- Are price effects being felt only in specific markets?
- Is segmentation in the office investment market increasing?
- To what extent are such clientele effects likely to be temporary or persistent?

Co-investment alongside discretionary funds: a growing trend

SUMMARY OF AN IPF PANEL DISCUSSION

Organisations co-investing in the funds they manage is a well-established path. What is new is the increasing number of investors who are making co-investment commitments alongside their allocations to discretionary funds.

The IPF organised a panel discussion in October 2015 to explore the rationale for this emerging trend and to take a look at the strategies for securing and deploying co-investment capital.

The participants were:

Chairman: **Justin Cornelius**, Berwin Leighton Paisner (JC)

Panel members: **John Harding**, BlackRock (JH)
Damien Smith, The Townsend Group (DS)
Rob West, Clearbell Capital (RW)

JC: TO WHAT EXTENT HAS CO-INVESTMENT FEATURED IN YOUR RESPECTIVE ORGANISATIONS?

DS: Townsend is a large advisor to the US pension fund community with approximately $150bn of capital under advice, which is invested across all forms of real estate investment. Townsend's discretionary business has approximately $14bn of assets under management (AUM) and has approximately 20% in non-primary fund investments including co-investments.

RW: Clearbell Capital manages two private equity funds. The second fund, which closed in 2014 and focuses on fringe London, South East offices and UK-wide logistics, has now committed to about £100m of co-investment, of which about 25% is UK-based.

JH: BlackRock currently manages about $4.5tn in assets, of which $22bn is held in private and public real estate across the equity and debt spectrum on behalf of investors worldwide. We frequently invite investors to co-invest alongside our funds.

JC: WHAT ARE THE ATTRACTIONS OF CO-INVESTMENT TO FUND MANAGERS AND INVESTORS?

DS: Co-investment can be additive to managers, particularly at the start and at the end of the fund life to assist with capital management and portfolio construction. We do see discrete differences in approach between US and European fund managers – the former tend to be more proactive in seeking co-investment partners.

RW: All capital is 'good' from a manager's perspective. Some limited partners insist on co-investment rights. It has a number of benefits, including access to

"...there is an opportunity to build very productive relationships."

additional capital. The most recent Clearbell transaction at £150m+ was too big for the fund on its own so it was helpful to be able to draw on £35m from two co-investors. Also there are the additional fees and the opportunity to build relationships with co-investors, including making presentations to co-investors' boards and so on.

DS: I agree there is an opportunity to build very productive relationships. Three years ago, Townsend was involved in a deal in Paris with a sovereign client and a local fund manager. The client and manager are exploring other opportunities to do more together.

JH: The desire for co-investment also poses challenges for managers. For example, during the fund raising process, if everyone says, "I want to co-invest but not be part of the fund itself", then the fund will never launch. Managers may require some investment in the fund as a prerequisite for being able to co-invest but this is not always case. Managers are also commercial and will accept co-investment capital, particularly when conditions are such that it is hard to raise capital in the market.

> *"Managers may require some investment in the fund as a prerequisite for being able to co-invest"*

RW: Also there has not been the same recovery in fee levels that were seen in previous cycles so currently co-investors have a lot of influence.

DS: Co-investment is attractive to large investors who feel investing in funds has its limitations when problems arise, as we saw in the last crisis. Some of these groups are now investing to build their own in-house investment teams but co-investment does offer access to expert management teams and the ability to invest with conviction and fix problems should they arise.

> *"..co-investment does offer access to expert management teams and the ability to invest with conviction and fix problems should they arise."*

JH: Co-investment can also be a solution to certain limitations. For example, some investors have a limitation on their concentration within a certain fund. Co-investments can allow them to access deals they believe in with managers they trust.

JC: ANY THOUGHTS ABOUT ISSUES ARISING DURING SPECIFIC CO-INVESTMENT TRANSACTIONS IN WHICH YOU HAVE BEEN INVOLVED?

RW: Clearbell has done four co-investment deals in the current fund. The most recent (August 2015) was the purchase of the Amber portfolio of 29 assets for £153.5m (as previously mentioned). This was funded by £70m of equity, being co-investment from a client of Franklin Templeton Real Asset Advisors and an overseas pension fund (each took a 25% stake), and a five-year senior loan at 65% loan-to-value. The key issue was getting decisions made quickly enough, given that there was only six weeks between having the offer accepted and going unconditional, with needing to do due diligence and get all approvals in place. At the start, there was a third potential co-investor but it decided not to proceed in light of the tight timescale and equity allocation.

JH: This underlines one of the challenges for fund managers – co-investors often do not have the resources to be able to respond in time. I am aware of a number of instances where investors have been keen to co-invest in a deal alongside the fund but when the time comes to act, they cannot drop everything else they are working on in order to perform the necessary due diligence in the allotted time.

DS: As a co-investor we do very comprehensive due diligence, even though the fund has already done this. Others are happy to rely on the manager's due diligence. It comes down to an investor's level of internal resource, the level of due diligence and underwriting by the manager and whether the deal under consideration fits their investment strategy.

Townsend is increasingly being asked to undertake the due diligence and underwrite the deal. We look at:

1. Is the deal attractive from a risk/return perspective;
2. Are we happy to underwrite the level of risk in the deal itself; and
3. Are we happy to underwrite the abilities of the fund manager.

Currently, the conversion rate from the deals in our pipeline is about 10%.

JC: WHAT ABOUT CO-INVESTMENT BY THOSE NOT IN THE FUND?

DS: Limited partners who commit to the fund should expect to have first rights. However, if existing investors cannot commit in a timely manner to secure the investment, external co-investment should be considered.

RW: We offer co-investment opportunities to our investors in the fund first and we will also look to use the monies in the fund first.

DS: We are seeing funds sharing a deal where their respective co-investors have said 'No'. In these club deals each group has a 'voice' proportionate to its investment.

RW: It is much easier to work with co-investors rather than another fund. Having said that, we have just done a deal on a speculative development, 50:50 with another fund and are using an external development manager.

> *"It is much easier to work with co-investors rather than another fund."*

JC: WHAT ABOUT MANAGEMENT FEES?

JH: I have seen a range of fees. It seems to depend on where we are in the cycle and the purpose of the co-investment capital. Some say the fees should be 50% of what they would be for investors in the fund but I have seen other institutions offer a range from full fees to no fees for co-investment.

DS: In the US, the rule of thumb is 50% of fund fees. We have not participated in deals where the fund managers demanded full fees. We've seen examples where competing managers have co-invested into deals together where clearly no additional fees are payable. One has to have an open mind. If the deal is immensely sensible after tax and on a risk/return basis, then one should be more flexible on fees.

JC: DO YOU EXPECT THE TREND TOWARDS CO-INVESTMENT TO CONTINUE AND WILL IT PUT MORE PRESSURE ON MANAGERS TO DEPLOY CAPITAL?

JH: I think it is cyclical but also a factor of market maturity. In the US, it is standard practice – in Europe it is still developing and we are learning from our private equity counterparts. At certain points in the cycle it is easier to raise capital so managers give away fewer concessions.

DS: I think co-investment is a trend that is here to stay. I do not think it should put pressure on managers to deploy more capital but should be additive to both the manager and the fund to access investments that may otherwise be too large for the fund.

RW: From a short-term perspective, we would like to do more co-investment as it enables us to build strong relationships and access to capital when we need it. There has not been a noticeable slowdown in demand as yet but, as the market strengthens, we have to remain disciplined as to how we underwrite returns.

> *"At certain points in the cycle it is easier to raise capital so managers give away fewer concessions."*

JC: HOW DO YOU MANAGE A GROUP OF INVESTORS, EACH OF WHOM WANTS THE RIGHT TO CO-INVEST?

RW: It is not an easy process to manage. However, in practice, not all investors go ahead, particularly given that one has to impose strict timetables. Also, the pro-rata share may be too small – as was the case for one of our co-investors on a deal we did near Canary Wharf.

DS: One does get to the stage where the allocation is too small. For us, anything less than $10m does not make sense. The 'sweet spot' to invest is circa $50m. We can go higher or lower but this level provides guidance to fund managers.

JH: It is important to have a strong relationship with ones co-investors such that you know what they are likely to do. It makes the whole process a lot more efficient.

QUESTION FROM JOHN FORBES (IN THE AUDIENCE): IN 2008, THINGS DID NOT GO WELL DUE LARGELY TO LACK OF ALIGNMENT. HOW CONFIDENT ARE YOU NOW WITH CO-INVESTMENT/FUNDS RELATIONSHIPS THAT THERE ARE PROVISIONS IN PLACE TO DEAL WITH SITUATIONS, WHERE, FOR EXAMPLE, THERE IS NEED FOR NEW CAPITAL AND SOME INVESTORS ARE UNABLE OR UNWILLING TO GO ALONG WITH THIS?

RW: Pretty comfortable that we are aligned. Also we have a different leverage perspective (compared to 2006); we are at 50-60% now.

JC: Current fund documentation better addresses the issue of managers not performing as expected. Co-investors now have recapitalisation rights where the they can put in more money even if the fund does not.

DS: Recapitalisation rights exist at fund level but these differ between funds. Some co-investors have control rights so they can amend an individual investment business plan to allow for problems, but not at the fund level.

JC: Funds have a fiduciary duty to revert to their investors and it is essential that they communicate openly with them. There is a big difference between investors being unhappy with the investment they made and the fund manager itself.

"...big difference between investors being unhappy with the investment they made and the fund manager itself"

RW: If a deal goes wrong it is a test of the co-investors/fund manager relationship. I would like to think that should it happen to us that we would come out of it positively.

Pricing retail space

MARTIN SUMMERSCALES & MATT THOMPSON
CBRE

The rise in multichannel shopping has fundamentally changed the retail industry. The assessment of the value of physical stores by retailers and landlords has become increasingly complex and is an area that requires investigation. Whilst a retailer may not recognise a sale via an alternative channel within an individual store's turnover, the store may still have played an important role as a customer 'touch point' in the transaction process. There is currently no established way of recognising this role and measuring the impact on overall retailer performance.

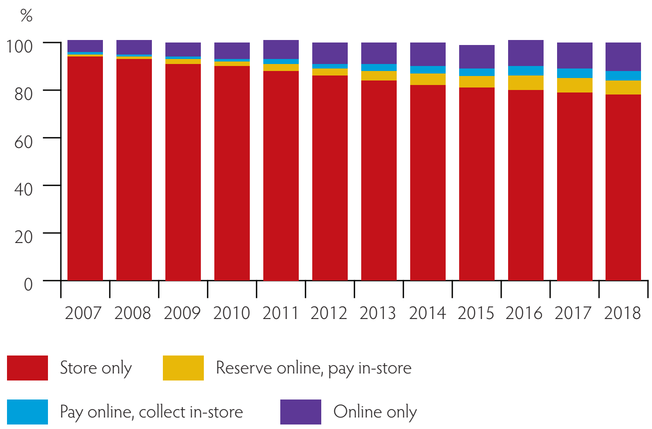
The authors were commissioned by the IPF Research Programme to investigate the extent to which physical stores add value to retailers, beyond their traditional role as 'transaction space'. The research report[1] was published by the Programme as part of its 'Short Paper' series in July 2015. This article outlines the key parts of this research.

Store productivity

Figure 1 shows that 90% of all retail spending still involves a physical store, although this is forecast to reduce slightly to 88% by 2018. To calculate the value of a bricks and mortar presence in the present-day multichannel environment, understanding the change in productivity of a unit when compared with a pre-multichannel environment is important. Productivity is defined in this context as the profit made on sales of products across all channels in which the store plays a part in a customer's purchasing activity.

The Theoretical Store Productivity Model (TSPM), developed during the course of the research, estimated the sales change, margin and additional channel benefits attributable to a store in a multichannel market draws comparisons with store productivity for retailers in a pre-multichannel retail market.

Figure 1: **Shopping spend by channel**



Source: Conlumino

As there is a lack of primary data, the validity of the inputs to the TSPM comparisons (shown in Figure 2) were underpinned by undertaking cross-sector sales analysis, retailer interviews and desktop research.

1 **Short Paper 26: 'Pricing Retail Space'** by Martin Summerscales and Matt Thompson, CBRE, published by the IPF Research Programme, July 2015.

Figure 2: **Theoretical Store Productivity Model (TSPM)**

1. Pre-multichannel store productivity model

Store productivity =
(In-store sales – In-store cannibalisation) x In-store margin

2. Multichannel store productivity model:

Store productivity =
(In-store sales – In-store cannibalisation – Pure play impact)
x In-store margin + (Online halo x Online leakage) x Online margin
+ Click & Collect sales x Click & Collect margin

NOTE: The definitions of these inputs and the values attributed to them are included in the research report.

The impact of multichannel retailing by sector and location

The TSPM analysis supports the hypothesis that multichannel retailing brings additional value to some retail property. However, the degree to which this is the case is dependant on the nature of the product sold and the type of location.

There was a significant difference between the higher productivity for fashion, catering and health & beauty retailers in prime city centres and regional shopping centres and weakening productivity for grocery and electrical retailers, particularly in secondary high street locations. This polarisation is demonstrated in Figures 3 and 4.

Figure 3: **Fashion – unit productivity since pre-multi channel environment**

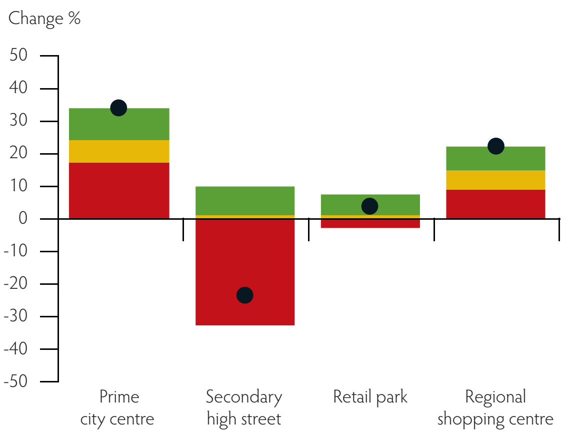
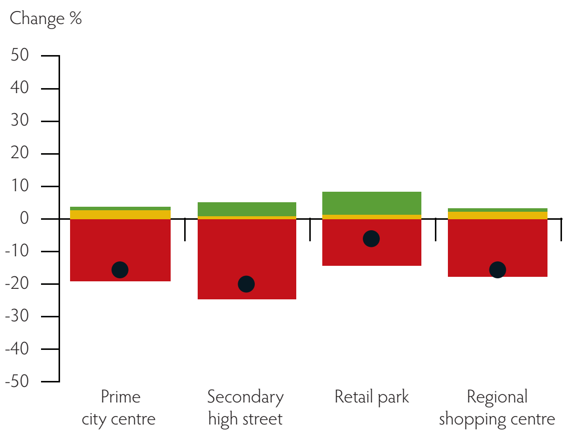


Figure 4: **Electrical – unit productivity since pre-multi channel environment**



In-store productivity | Online productivity | Click & Collect productivity | Total change in store productivity

As regards fashion retailers (see Figure 3), significant growth in prime city centre productivity is driven primarily by stronger in-store densities. Click & Collect generates further productivity, due to the convenient location, near to home and/or the workplace. Prime city centre also benefits from an additional online sales halo from flagship stores, as new customers engage and acquaint themselves with the brand, encouraging online purchases.

Similar to prime city centre locations, higher regional shopping centre footfall and higher customer spending drive stronger in-store sales densities for fashion retailers. Upgrades to Click & Collect facilities also support higher productivity for fashion retailers using this channel. By contrast, secondary high street locations are less productive in a multichannel environment, due to weaker in-store sales densities, as consumers prefer to shop at prime locations or choose home delivery options. Additional Click & Collect sales are not sufficient to offset the fall in sales.

On retail parks, fashion retailers benefit from easily accessible and convenient locations for Click & Collect fulfilment. This leads to higher store productivity compared with the pre-multichannel environment, although any change in in-store sales densities or impact of an online halo are negligible.

The overall decline in electrical store productivity (see Figure 4) is due to a sharp decline in in-store sales. The need for customers to sample and test electrical goods before purchasing remains unchanged in the multichannel environment. However, price comparison through online websites drives consumers to test products in-store (showrooming) and then shop online.

The conclusions drawn from the model show a movement in demand for different retail locations but retail sub-sector and location types are not the sole drivers of store affordability. Currently, few UK retailers offer consumers a seamless multichannel shopping experience. To maximise the value of a location's potential, retailers must continue to develop their sales channels, which may require considerable investment in new technology as more options, such as the beacon app, become available to consumers.

Considerations for investors

PRIME CITY CENTRES

Flagship stores in prime city centres contribute towards showcasing retailer brands; this is particularly important for new retailers entering the UK market. New entrants can expect stronger online sales uplift following a flagship store opening, as new customers engage and acquaint themselves with the brand, in addition to driving strong in-store sales densities.

This clear link between in-store and online sales in prime city centre locations brings additional value to a retail property and supports rental affordability in an otherwise seemingly unaffordable market. In view of this, central London's key shopping streets are likely to experience an increasingly diverse mix of new international fashion retailers that will seek to capitalise on the strongest levels of non-store productivity. Furthermore, UK multiples are likely to experiment with new store formats, including growth into upper levels, as a result of the additional value added for both retailer and landlord in this type of location. Conversely, retailers with limited online operations, such as discount retailers and grocers, are more likely to feel the pressure from rising rental levels in key shopping streets in prime city centres across the UK.

> *"...link between in-store and online sales in prime city centre locations ... supports rental affordability in an otherwise seemingly unaffordable market."*

SECONDARY HIGH STREETS

While the high street was once a one-stop location, it is only the discount and catering sub-sectors that have experienced an improvement in store productivity here in the multichannel environment.

Sectors like fashion and electrical goods have experienced a weakening of in-store sales so they are likely to adopt smaller formats to drive stronger sales densities and to fulfil Click & Collect orders. As a result, many UK high streets now suffer from a surplus of retail space. Arguably, this presents an opportunity for catering or independent operators to capture trade from high street footfall. Additionally, surplus high street space may benefit from a change of use to residential and/or community activities, particularly in the South East, where housing demand is strongest.

RETAIL PARKS

Retail park locations are well-placed to support retailers in the delivery of a multichannel offering. However, the additional productivity from non-store channels witnessed by grocers and electrical retailers is shown to be insufficient to offset the decline of in-store productivity. The upshot of this is that many retail parks will shift their offer towards fashion retailers and catering services so that key regional retail parks could become as strong as regional shopping centres in terms of spend and footfall levels.

> *"...many retail parks will shift their offer towards fashion retailers and catering services..."*

The most profitable locations are also key targets for growing A3 operators (restaurants and cafés), which will be attractive to landlords as they seek to increase dwell time on site.

SHOPPING CENTRES

Unique flagship store formats in regional shopping centres drive stronger in-store sales densities for fashion and health & beauty retailers. The improving in-store performance in a multichannel environment is coupled with additional value to the online sales channel, particularly given free wifi in these centres.

> *"...strong outlook for sales growth across all retailer sub-sectors in shopping centres."*

As demand for space continues to grow in these key centres, developers will continue to exploit refurbishment and extension opportunities to support demand and maintain rental growth. Such continued investment will reinforce the strong outlook for sales growth across all retailer sub-sectors in shopping centres.

The additional benefits from Click & Collect fulfilment and an additional online sales halo allow fashion and health & beauty retailers to support higher rental levels than discount, grocery and catering operators. The retailers in the latter categories might be expected to rationalise their store footprint as a consequence of squeezed rental affordability.

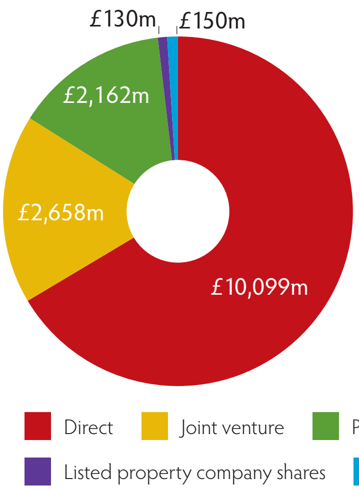
Institutional attitudes to UK residential property

'At a Glance'

The IPF undertakes an annual survey of institutional investors to measure the current level of investment and future intentions, whilst also seeking reasons for not investing from non-investor respondents. The fourth 'UK Residential Property: Institutional Attitudes and Investment Survey' was published in August 2015. More than 80 organisations were invited to participate in the research and responses were received from 47 of them. The key findings are summarised below.

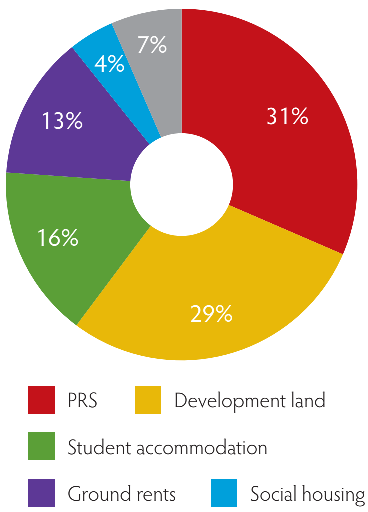
- 2015 survey participants held in excess of £3tn of assets under management – real estate comprised approximately £220bn or circa 7.3% of these holdings.
- The cumulative value of the UK residential holdings of the 36 respondents providing such data was £15.4bn (circa.7.5% of all UK real estate assets). Average holdings per investor were just under £428m.

Figure 1: **Respondents' route to investment**



- Direct ownership was the preferred method of holding for the majority of respondents, representing around 66% by value of all residential assets disclosed (see Figure 1).
- Just under half of respondents invested through joint ventures and a third used private funds. Four investors gained exposure via listed property company shares (1% of total residential investment).
- Investment in the private rented sector (PRS) was marginally the most popular type of investment (31% of all assets); development attracted just under one-third (29%) of the total, followed by student accommodation (16%).

Figure 2: **Respondents' investment by asset type**



- 18 contributors provided data on their development activities. The gross development value of these projects totalled £10.7bn. 60% of the pipeline was earmarked for disposal; eight contributors intended to sell on completion whilst five were building exclusively to rent.
- The principal rationale for investing in residential was its returns profile, followed by development potential. Stability of income was also a major attraction.
- Nine of the participants did not invest in residential; low income yield was cited by all as an important issue. Two respondents had no intention of investing in the future and only one quantified their investment intentions for the next three years, stating a preference for investment in PRS and student accommodation.
- More than half of existing investors planned to increase investment over the next 12 months, with three expecting to reduce their exposure. The scale of potential new investment was approaching £6.5bn. PRS remained the most favoured sector with £2.89bn (or 45%) earmarked for this segment, followed by development (£1.52bn or 24%).

New UK GAAP – more than an accounting change

AVNI MASHRU AND SANDRA DOWLING
PwC LLP

The accounting guidance that has been applied in the UK for over 25 years is being replaced by a new regime (New UK Generally Accepted Accounting Principles or GAAP). The standards are much shorter than those they replace and, in general, align more closely with International Financial Reporting Standards (IFRS), though the accounting provisions of the Companies Act 2006 continue to apply. The new standards are mandatory for periods beginning on or after 1 January 2015.

The centre piece of the suite of new financial reporting standards is FRS 102, 'The financial reporting standard applicable in the UK and Republic of Ireland', as this effectively replaces the old UK standards. Certain group entities also have the choice of adopting FRS 101, 'Reduced disclosure framework – Disclosure exemptions from EU-adopted IFRS for qualifying entities' which is effectively IFRS measurement with reduced disclosures.

It is not just accountants who need to know about new UK GAAP – it will impact many areas such as cash tax, dividend extraction, valuations, banking covenants, systems and processes.

What might change for property companies and groups?

There are many aspects of accounting that may be different under new UK GAAP as well as having a wider impact. For example, the benefit of lease incentives is recognised by lessees over a longer period than under old UK GAAP, which could lead to delays in dividend extraction (although this does not need to be applied to leases existing on transition). But one of the key changes under FRS 102 is that it is likely that more items will need to be carried at fair value on the balance sheet. This may apply to intercompany loans that have an off-market interest rate and derivatives.

When it comes to investment property, under old UK GAAP, property leased to other group companies was specifically excluded from the scope of the investment property standard and was accounted for in the same way as other owner occupied property. However, under FRS 102, there is no equivalent scope exclusion so more properties will fall to be treated as investment properties and held at fair value. Arguably classifying these properties as investment properties and measuring them at fair value provides more relevant information to users than a calculation of systematic annual depreciation.

Can fair value accounting be avoided?

FRS 102 requires measurement of investment property at fair value, provided this can be reliably determined 'without undue cost or effort'. Where fair value is not available 'without undue cost or effort' properties should be accounted for as property, plant and equipment i.e. at cost less depreciation. There is no further clarification in the standard as to the application of 'undue cost or effort'; the phrase does not have a unilateral meaning, rather it will need to be interpreted in the context of individual circumstances.

Transition to FRS 102: An example of the impact for entities and groups with investment properties

This example assumes the following scenario:

The reporting entity, RepCo, produces both consolidated and stand-alone financial statements. It is presenting FRS 102 accounts for the first time for the year ending 31 December 2015 having previously presented the financial statements under old UK GAAP.

RepCo, owns an office block in Manchester. Five floors are occupied by RepCo, itself, while two floors are rented to a subsidiary under an operating lease.

Under Old UK GAAP, the whole building was treated as a fixed asset (property, plant and equipment or PPE) and held at cost less depreciation in accordance with FRS 15, 'Tangible fixed assets'.

In the individual accounts of RepCo, under FRS 102, the five owner-occupied floors will remain as PPE but the two rented floors will be treated as investment property and be held at fair value. The fair value movements will be recognised in the profit and loss account (P&L). In the group accounts the whole property will remain as PPE.

In making the 'undue cost or effort' assessment, all angles should be considered including external factors (nature and location of properties) as well as internal factors (availability of resources). The assessment will be different for each company and judgment will be required in determining whether the cost or effort required to measure fair value genuinely outweighs the shareholder benefits of such information.

What about profit impact and dividends?

Under FRS 102, movements in fair value are recognised in the P&L rather than in the statement of total recognised gains and losses (STRGL) as under old UK GAAP. This combined with the increased scope for recognising investment property under FRS 102, means that there may be more profit and loss volatility. However, when it comes to declaring dividends, directors must still assess whether amounts recognised in the P&L are realisable/distributable for that purpose.

What can I do?

Potential pitfalls can be avoided by channelling the right resources, time and effort to a transition project now and considering the wider implications as early as possible.

IPF legal and regulatory round-up

AMANDA HOWARD, Nabarro

This is an overview of key recent and upcoming legal developments affecting UK real estate investment in the fields of tax, general UK property law, energy and environment, planning and development, financial regulation, investment fund vehicles, IT, finance, residential ownership and insolvency. The list follows no particular order and is intended as a non-exhaustive and high-level introduction to some of the main legal developments facing the industry.

Legal developments – tax

TAXATION OF INVESTMENT MANAGERS

2015 has brought major changes to the UK tax treatment of cash rewards arising to executives from investment funds. These changes affect both management fees and performance rewards (carried interest) although they should not impact on genuine co-investment returns to managers.

The first change applies to 'disguised management fees' and provides for sums that managers receive for their investment management services via partnerships or other transparent vehicles to be subject to income tax. This measure is intended to stop managers converting into capital receipts that which the Government considers to be trading income. The new rules stipulate that if an individual provides investment management services for a collective investment scheme or an investment trust through an arrangement involving a partnership, any sums received for those services will be treated as profits of a trade, unless already charged to income tax as employment or trading income. Sums will not be caught if they represent 'carried interest' (as defined in the legislation) or constitute a return of capital that the individual invested.

The second change applies to carried interest arrangements and removes the long established benefit of 'base cost shift'. Broadly, base cost shift was a (cost-free and tax-free) transfer to the carried interest holders of part of the investors' base cost in the fund's assets, reducing the carried interest holders' gain that was subject to Capital Gains Tax (CGT). Under the new rules deductions are only allowed for sums that the carried interest holders actually give as consideration for acquiring the right to that carried interest (usually a fairly nominal amount) so base cost shift is no longer available.

Finally, the UK Government is currently consulting on changes to the taxation of performance fees arising to fund managers in relation to their management activities. The consultation is looking at two possible ways to determine whether underlying fund income should be regarded as income or capital. The first option looks at the underlying fund assets to determine whether capital treatment is appropriate (with 'good' and 'bad' asset classes). The second looks at the average length of ownership of a fund's assets, the current suggestion being that where a fund holds assets for four years, capital treatment would be available to managers.

Timing

The rules governing disguised management fees were introduced in the Finance Act 2015 and have effect for sums arising on or after 6 April 2015 regardless of when the arrangements giving rise to the sums were made.

The new carried interest rules were announced in the July 2015 Budget and the relevant provisions are contained in the Finance (No.2) Bill 2015. Although the Bill has not yet received Royal Assent, the provisions will have effect in relation to carried interest arising on or after 8 July 2015 and unconnected with the disposal of an asset or assets of a partnership or partnerships before that date.

The consultation concerning performance fees was launched on 8 July 2015 and draft legislation is expected to be published at the 2015 Autumn Statement. The legislation is intended to take effect from 6 April 2016.

Comments

The attack by a Conservative Chancellor on the well-established favourable tax regime for investment managers came as a shock to many. Specifically, the post-election changes to carried interest base cost were not anticipated by the industry.

With further changes on the horizon in respect of performance fees, real estate funds will need to consider carefully how best to incentivise their management teams whilst still trying to align the interests of managers and investors.

DIVERTED PROFITS TAX (DPT)

DPT was announced during the 2014 Autumn Statement as a measure designed to combat perceived avoidance by the likes of Amazon and Google (hence its nickname in the press: the 'Google tax'). The Government's stated intention was to 'introduce a new tax to counter the use of aggressive tax planning techniques used by multinational enterprises to divert profits from the UK'.

DPT achieves its objective of countering the use of aggressive tax planning. However, it goes further than just taxing profits diverted from the UK. It taxes profits that have some connection with the UK but would not otherwise be subject to UK tax and are not being taxed elsewhere. Broadly, DPT can apply in two circumstances:

Timing

Legislation introducing DPT was included in the Finance Act 2015 and applies with effect from 1 April 2015.

HMRC has published 'interim guidance' on the new tax. There is no set time frame for the production of final form guidance.

Comments

DPT has the potential to cause concerns for a number of real estate funds with offshore entities within their structure who invest in UK property. Whilst there is an exclusion from the rules for groups with fewer than 250 staff and which have an annual turnover not exceeding €50m or an annual balance sheet not exceeding €43m, there is no general exemption for property businesses. This is not an oversight: HM Revenue & Customs (HMRC) have stated that the rules are intended to apply to property funds in certain circumstances.

There is an example in HMRC's interim DTP guidance detailing how the rules would be intended to apply to a sale and leaseback transaction involving UK property. This example (and other uncertainty surrounding the application of the new rules) has led to discussions between HMRC and UK property industry bodies in an effort to clarify the extent of the impact of DPT on property funds. These discussions are on-going but HMRC have so far

1) where an intra-group expense has been created (or there is a diversion of intra-group income), the arrangements lack economic substance, the arrangements exploit a tax mismatch and it is reasonable to assume that the expense would not have been incurred if not for the tax benefit; and

2) where, despite activity being carried on by a person in the UK, a company avoids creating a UK permanent establishment (PE).

DPT is charged at a (deliberately penal) rate of 25%: much higher than the main corporation tax rate (currently 20% and set to reduce to 18% by 2020). The legislation has been carefully crafted so that the tax falls outside the remit of any Double Tax Treaties entered into between the UK and other jurisdictions. Accordingly, DPT may be imposed notwithstanding any treaty protections that might otherwise apply.

confirmed that the rules are not aimed at structures where an offshore company is registered as a non-resident landlord (NRL) and pays income tax on income derived from UK property at 20%. However, due to the mechanics of the legislation, NRL structures can be caught and will need to work through the relevant rules.

An arrangement is unlikely to fall within DPT unless it can be reasonably assumed to have been designed to secure a tax reduction. Interest and capital allowances could result in a tax reduction as defined, but HMRC agree that it is difficult to envisage a scenario where these deductions would be the main driver of a transaction.

There remains a great deal of uncertainty surrounding the application of the rules in practice. In addition, although the Treasury disagrees, some commentators are suggesting that the UK's DPT regime may need to be amended or even repealed in light of the international BEPS proposals (discussed below).

BASE EROSION AND PROFIT SHIFTING (BEPS)

In July 2013, the Organisation for Economic Co-operation and Development (OECD) published an Action Plan commissioned by the G20 on Base Erosion and Profit Shifting (BEPS). The aim was to address perceived weaknesses in international tax rules that allow multinational businesses to avoid or minimise taxation. The BEPS Plan proposes 15 Actions which, broadly, fall into three categories:

1) actions to strengthen or amend existing domestic legislation (such as controlled foreign companies rules, transfer pricing rules and rules dealing with hybrid mismatches);

2) actions to introduce new rules (for example, a new definition of 'permanent establishment' and new rules to ensure that tax treaties cannot be used to generate double non-taxation); and

3) actions to require disclosure and transparency (for example, by requiring taxpayers to disclose aggressive tax planning arrangements).

Of particular interest to the real estate funds industry are Action Points 4 (dealing with interest deductions) and 6 (dealing with tax treaty abuse). Action Point 4 recommends that net tax deductible interest payments should be limited to a maximum of 30% of EBITDA. This test would be applied to all interest payments, irrespective of whether they relate to intra-group or third party financing. As a consequence of implementing these recommendations it is likely that the UK will need either to amend or repeal its current interest restriction regime known as the World Wide Debt Cap.

Action 6 aims to prevent tax treaty abuse by ensuring that all treaties include provisions which either:

1) limit access through a 'limitation on benefits' (LOB) rule; or

2) prevent treaty benefits from being obtained where obtaining treaty benefits was one of the main reasons for entering into an arrangement.

Option 1) has been widely criticised for being too subjective, meaning that much focus has been placed on the LOB rule. This rule poses particular problems for property funds because a number of legitimate property investment arrangements would be denied access to tax treaty benefits under the current proposals.

Timing

Final Reports for all 15 Actions were published in October 2015.

The BEPS proposals will be presented to the annual summit of G20 leaders in November 2015.

There is still some way to go before the recommendations on each Action Point can be translated into law: each Action Point has its own time frame for consultation and implementation, generally in 2016-17.

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Comments

Inherent in the international scope of the BEPS Project are uncertainties surrounding when, how and whether recommendations will be adopted by different jurisdictions. The UK has played a pivotal role in driving the BEPS project forward and has chaired various Action Groups, including Action Point 15 on developing the instrument which will implement changes to the international tax treaty network. As a result, it can be expected that the UK will take a leading role during the implementation stage and set an example to other jurisdictions by making the necessary changes to UK tax law.

Given that the real estate sector relies more heavily on debt finance than most other sectors, UK industry bodies have expressed concern about the potential impact of the Action 4 recommendation to restrict net tax deductions for interest payments to between 10% and 30% of EBITDA. A UK consultation paper on Action 4 was published on 22 October 2015.

There are also concerns within the industry that Action 6 does not provide any clear guidance as to how legitimate collective investment schemes and property SPVs will be able to access treaty benefits in the event the proposed 'limitation on benefit' provision is included in tax treaties.

CAPITAL GAINS TAX (CGT) FOR NON-RESIDENTS

Following the 2014 consultation on the extension of CGT to gains made by non-residents disposing of UK residential property, legislation was enacted earlier this year.

CGT now applies where non-resident individuals, non-UK resident partners of partnerships, some non-UK resident companies, non-UK resident trustees and narrowly-marketed offshore funds dispose of residential property in the UK.

The default position is that the charge applies only to gains since 5 April 2015 so it was advisable for non-residents to get their UK residential property assets valued as at 6 April to enable them to calculate charges going forward.

Widely-held funds and institutional investors should not fall within the new rules.

The rate of CGT that applies to non-residents is the same as that which would apply if the relevant entity was based in the UK (either 18% or 28% for individuals depending on the extent of the individuals' taxable income and gains, 20% for companies and 28% for trustees). The changes apply to gains realised since 5 April 2015.

Timing

The new rules were included in the Finance Act 2015 and apply to all disposals on or after 6 April 2015.

Comments

During the consultation phase, there was widespread concern that the measure could significantly reduce overseas investment into the UK residential property market by imposing CGT on residential property funds. This concern was largely addressed in the final legislation by including an exception from the rules for companies that are not 'narrowly controlled'. Only non-resident companies controlled by five or fewer persons now fall within the scope of CGT. A company is not regarded as being controlled by five or fewer persons if one of the controlling parties is a diversely held company or a qualifying institutional investor. Most residential property funds can make use of this exception to fall outside the new regime.

There was also a concern that the rules would have serious implications for the student accommodation market in the UK as consultation discussions noted that student accommodation fell within the proposed definition of 'residential property'. Following lobbying from the industry, the enacted legislation includes an exemption from charge for disposals of purpose built student accommodation (including at least 15 bedrooms), as well as care and nursing homes and hotels.

Legal developments – general UK property law

RIGHTS OF LIGHT REMEDIES

An important 2014 case on remedies in rights of light cases (Coventry v Lawrence) has been tested in practice (in Scott v Aimiuwu).

In Coventry v Lawrence, the Supreme Court heavily criticised the tendency of courts to slavishly apply existing principles to award an injunction rather than damages in a rights of light case. It endorsed a more flexible approach, suggested that wider factors, including planning consent, should be taken into account.

In Scott v Aimiuwu, the Scotts argued that the Aimiuwus' extension infringed their rights of light and they issued a claim for a mandatory injunction, for the development to be cut back.

The judge refused to award the injunction. He decided that an injunction would be oppressive, and that the burden to the Aimiuwus would outweigh the benefit to the Scotts. He also commented that the Scotts' main concern was financial – the loss of value to their property – rather than the loss of light itself. With this in mind, he awarded the Scotts damages of £31,499.

Timing

The Scott v Aimiuwu decision was dated 18 February 2015.

Comments

This is good news for developers. The case will give hope that courts will more regularly award damages rather than an injunction, as a remedy in rights of light cases.

ENFORCEABILITY OF NON-REFUNDABLE DEPOSIT CLAUSES IN PROPERTY TRANSACTIONS

Generally, if a buyer of a property pays a non-refundable deposit in the course a transaction, the buyer will lose that deposit if he fails to complete.

However, if the court considers that the deposit is unreasonable – and a penalty clause – the court can order the seller to return the deposit to the buyer. In a property transaction, a deposit of 10% or less is usually reasonable and not a penalty.

Two recent cases on penalty clauses (Parkingeye v Beavis and Cavendish Square Holdings v El Makdessi) have been heard by the Supreme Court and are expected to impact on the general presumption.

Timing

The Supreme Court gave its decision on 4 November 2015.

Comments

The Supreme Court decision endorses the Court of Appeal, which seems to be moving away from the simple test of whether a payment is a 'genuine pre-estimate of loss', when assessing whether a clause may be a penalty.

For property contracts, this judgment may open up a line of argument that a 10% (or less) deposit may still amount to a penalty.

RECOVERING RENT PAID BEFORE A BREAK DATE

The Supreme Court has heard the case of Marks & Spencer v BNP Paribas, one of the most eagerly awaited property litigation cases of 2015.

Currently, a tenant usually has to pay rent for the entire quarter, even if it has exercised a break option and the lease has ended mid-way through the quarter. The tenant can only ask for a refund if there is an express clause in the lease or if it can argue successfully that it paid the rent for the period after the break by mistake.

The Court of Appeal had ruled that it was not appropriate to imply a term into the lease which would entitle the tenant to a refund of rent, car parking fees and insurance that it had paid in advance in accordance with the express terms of the lease.

Timing

The Supreme Court heard the appeal on 7 October 2015. The Supreme Court's decision is still awaited.

Comments

Landlords and tenants will be hoping for some clarity from the Supreme Court about payment of rent after the exercise of a break option.

The Court of Appeal decision had given comfort to landlords that, unless there is an express provision in the lease, a tenant will not be entitled to a refund of any rent paid for the period after a break date.

Both landlords and tenants are now eagerly awaiting the Supreme Court's view.

Legal developments – energy and environment

MINIMUM ENERGY EFFICIENCY STANDARDS

The Energy Act 2011 includes powers to make it unlawful to rent out business or residential premises if the premises are below a minimum energy efficiency standard. Regulations were made in April 2015 bringing these provisions in force and setting out the detailed requirements.

As expected, the minimum standard is an E rating on the EPC for the premises (both business and residential), subject to some detailed exemptions.

Lettings of business premises in breach of these Regulations attract a civil penalty of between £5,000 and £150,000 depending on the length of the breach and the rateable value of the premises. For letting of residential premises the maximum penalty is £5,000. The fact that a penalty has been imposed will be available on a public register.

Landlords should now be evaluating their portfolios, to identify properties which fall below an E rating and to consider whether an exemption might be available. Landlords should also review their standard lease terms.

Timing

For business premises, the minimum E rating will apply for new lettings from 1 April 2018 and for then existing lettings from 1 April 2023.

For residential premises the corresponding dates are 1 April 2018 and 1 April 2020.

Comments

The main exemptions, which will allow premises to be let from 1 April 2018 (or to continue to be let from 1 April 2020 (residential premises) or 1 April 2023 (business premises)) are:

- the works needed to bring the premises up to at least an E rating are not cost effective over a seven-year time period;
- a necessary consent to carry out the works cannot be obtained; and
- carrying out relevant works to improve the rating would result in a 5% reduction in value (an independent surveyor's report is needed).

To take advantage of an exemption, the landlord must register the fact that it applies and lodge supporting paperwork; the registration lasts for five years, but may be renewed. A purchasing landlord cannot use its seller's registered exemption, but must register an exemption (and supporting paperwork) in its own name.

IMPACT OF GREEN DEAL / ENERGY COMPANY OBLIGATION

The Energy Act 2011 also provides that private sector landlords of residential premises will be unable to refuse a tenant's reasonable request for consent to carry out energy efficiency improvements where a finance package, such as the Green Deal and/or the Energy Company Obligation, is available.

Timing

These provisions will come into force on 1 April 2016.

Comments

There are detailed provisions as to how a tenant must make a request and how a landlord must respond.

HEATING REGULATIONS

The Heat Network (Metering and Billing) Regulations 2014 (the Regulations) make provision for ensuring that tenants (whether residential or business) of multi-let buildings who have a central plant for heating, hot water and/or cooling systems are billed according to their individual consumption of energy.

The Regulations apply where heating, cooling or hot water is supplied from a central plant and is charged to tenants either directly or indirectly through service charges. Typical multi-let buildings would include:

- **multi-let office blocks;**
- **shopping centres;**
- **student halls of residence; and**
- **care homes.**

Timing

Landlords must register with the National Measurement Office (which will oversee the operation of the Regulations) by 31 December 2015 and must install individual meters/heat cost allocators for each occupier by 31 December 2016, unless it is not cost-effective or technically feasible to do so (and a complicated schedule to the Regulations explains how this is assessed).

Comments

There are civil and criminal penalties for failure to comply.

The Regulations do not touch on any question of whether the landlord has the rights of access to the tenants' premises needed to comply, nor on the question of what happens if the service charge provides for a different method of cost allocation.

Landlords will need to review lease terms to deal with this point for future lettings and check lease terms; they will probably be able to pass the cost of physical installation of meters/heat cost allocators to the tenants through the service charge (as a cost of complying with statute), but whether the administrative costs of updating billing systems for example could be recovered under a service charge is less certain.

ENERGY SAVINGS OPPORTUNITY SCHEME (ESOS)

ESOS obliges large private sector undertakings to carry out periodic energy assessments and report the results to the Environment Agency.

Timing

The Regulations establishing the Scheme implement Article 8 of the Energy Efficiency Directive 2012 and they came into force in July 2014. The date for determining whether the Scheme applies to a particular undertaking was 31 December 2014. Undertakings to which the Scheme applies must carry out the first assessment and report by 5 December 2015; subsequent assessments are required every four years.

Comments

ESOS applies to any undertaking which employs at least 250 persons or employs fewer than 250 persons but has an annual turnover in excess of €50m and an annual balance sheet in excess of €43m, or which is part of a corporate group which includes an undertaking which meets these criteria.

Carrying out an energy assessment involves measuring total energy consumption and identifying cost-effective energy efficiency recommendations.

If an undertaking is fully covered by ISO 50001 it does not need to carry out an assessment under this Scheme but it must notify the Environment Agency to confirm that it is covered by ISO 50001.

Legal developments – planning and development

PERMITTED DEVELOPMENT: OFFICE TO RESIDENTIAL

In October 2015 it was announced that the Government will introduce a permanent permitted development right for change of use from class B1(a) (offices) to class C3 (dwelling houses).

This will replace the temporary right which applied from 30 May 2013 up to 30 May 2016.

Timing

This will apply from May 2016.

Comments

This measure has been introduced to get more homes built to meet the Government's target of 1m new homes by 2020.

Whilst this permitted development right will only provide a small percentage of the Government's new homes target, it will ensure that underused commercial spaces are put to use and provide more certainty to developers or investors looking to convert offices into homes.

COMMUNITY INFRASTRUCTURE LEVY (CIL)

There are new restrictions on local planning authorities' use of section 106 planning obligations, which cannot be sought for infrastructure intended to be funded by CIL. In addition, no more than five obligations can be pooled by the authority to provide for the same item of infrastructure. This applies regardless of whether the local authority has adopted a CIL charging schedule.

Timing

This applies from April 2015.

Comments

These restrictions were designed to make it difficult for local authorities to raise revenue by other means and therefore encourage them to adopt CIL. However, by April 2015 the majority of local authorities had failed to adopt CIL and the impact of these restrictions will be a major threat.

The restrictions may also be of concern to developers or investors where the restrictions could block a proposed development or change of use because the method of making it acceptable in planning terms by securing section 106 obligations is no longer available.

HOUSING AND PLANNING BILL 2015-16

The Housing and Planning Bill 2015-16 had its first reading in the House of Commons on 13 October 2015. The Bill introduces a number of planning reforms including reforms to:

- **Speed up the neighbourhood planning process for communities seeking to meet local housing and other development needs through neighbourhood planning.**
- **Local planning, so that the Secretary of State has further powers to intervene if local plans are not effectively delivered.**
- **The Town and Country Planning Act 1990 to allow permissions in principle to be granted for development of land in England.**
- **Nationally significant infrastructure projects (NSIP), to allow developers who wish to include housing within major infrastructure projects to apply for consent under the NSIP regime.**
- **The compulsory purchase regime, so that it is a smoother and faster process.**

Timing

The Housing and Planning Bill 2015-16 had its first reading in the House of Commons on 13 October 2015.

Comments

The Bill aims to make planning processes more efficient and has a particular focus on ensuring the delivery of new housing to meet the Government's ambitious target of 1m new homes by 2020.

This is exemplified by the Government's announcement that local authorities must produce local plans for new homes in their area by 2017 or the Government will produce those plans for them, in consultation with local people. This should lead to a further impetus for the private rented and residential sectors but also intends to encourage development in general terms.

Legal developments – financial regulation

MARKETING OF PRIVATE REAL ESTATE FUNDS UNDER THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (AIFMD)

The European Securities and Markets Authority (ESMA) has published the results of its first review into the AIFMD fund marketing regime since the deadline for EU Member States to implement the Directive (July 2014).

Currently, EU alternative investment fund managers (AIFMs) based outside the EU must not market alternative investment funds (AIFs) to European investors under AIFMD. Instead they must comply with the national private placement regimes (NPPRs) in each European country in which they wish to market an AIF.

Third country managers:

ESMA is required to advise the European Commission on whether AIFMs from non-EU jurisdictions should be allowed to market funds to investors across Europe under the AIFMD marketing regime. This would entail non-EU AIFMs being allowed to obtain a licence or 'passport' from just one EU Member State regulator, as only EU AIFMs may currently do.

ESMA has published this advice, the key points being:

- **the passport should be extended to managers from Guernsey, Jersey and Switzerland (subject to the passage of certain changes to Swiss information sharing laws);**
- **more information/time is required before a decision on extending the passport to the managers from the US, Hong Kong and Singapore; and**
- **it is currently assessing whether the passport should be granted to managers from Australia, Canada, Japan, the Cayman Islands, the Isle of Man and Bermuda.**

Functioning of the marketing regime

ESMA is also required to give an opinion to the Commission on the current functioning of the AIFMD passport regime alongside the NPPRs. It is envisaged that the NPPRs may eventually be phased out.

ESMA has published its first opinion on these points. This accepted certain issues raised by the funds industry (particularly lack of consistency amongst European regulators) but concluded that AIFMD has not yet been in operation long enough to allow ESMA to recommend any specific changes.

Timing

The decisions on whether, to which countries and when the passport will be extended now rest with the European Commission. The precise timing is unknown.

ESMA is next due to give advice to the Commission on extending the passport to further jurisdictions in Q4 2016. ESMA may nevertheless report back on the passport in the first half of next year, with the earliest possible moment that the passport could be extended being summer 2016.

Comments

This affects private real estate fund managers and investors.

For now, the NPPRs exist in parallel with the AIFMD passport regime. This means that EU managers can market to EU investors via the passport or NPPRs, whilst non-EU managers can market only via the NPPRs.

Real estate AIFs in Europe are generally managed from an EU Member State or the Channel Islands. It seems likely that the EU will extend the passport relatively soon to the Channel Islands, meaning that most European real estate AIFs will have the choice of using the passport or NPPRs.

The big issue with extension of the passport is that it may lead to the shutting of the alternative NPPR route. However any such closure of the NPPRs is unlikely to happen for another few years if ever, particularly given the impasse between Europe and the US over equivalence (the EU is not comfortable with the US regime, and the US is unlikely to introduce its own new regime based on AIFMD). Shutting off the NPPRs would currently bar US fund managers from accessing European investors, which is unlikely to be acceptable at an EU policy level.

MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE II (MIFID II)

MiFID II and the accompanying Regulation (MiFIR) will soon replace the current securities trading regime under MiFID.

This new legislation will make changes to the regulation of investment firms, trading venues, data reporting service providers and third-country firms providing investment services or activities in the EU.

Timing

MiFID II will come into force on 3 January 2017.

Comments

Under AIFMD, AIFMs (including those managing real estate funds) providing portfolio management services must currently comply with certain elements of the MiFID regime, in relation to areas such as inducements, organisational requirements and conduct of business provisions.

MiFID II introduces several key changes to these obligations. These include requirements for these AIFMs to:

- refuse to accept or keep any fees, commissions or benefits (monetary or non-monetary) from any third party, or anyone acting on their behalf, who is involved in assisting them with providing services to clients;
- keep records of all of their activities, especially telephone conversations or electronic communications relating to concluded transactions and transactions intended to be concluded; and
- understand the financial instruments that they offer or recommend, and ensure that these instruments are only recommended when it is in the interests of the client. This also requires AIFMs to obtain the appropriate information on each financial instrument and understand the characteristics and identified target market of that instrument.

SOLVENCY II

Solvency II is a fundamental review of the capital adequacy regime for the European insurance and reinsurance industry. It deals with the amount of capital which EU insurance companies must hold in order to reduce the risk of insolvency. Solvency II brings in capital requirements for insurers similar to those imposed on banks in Basel III.

There are different capital requirements according to the asset types involved. The higher the perceived risk of an asset class, the more capital the insurer needs to set aside to ensure that, if its value falls, the insurer's ability to cover all its notional liabilities to policyholders is not affected.

Timing

Solvency II will apply to insurance firms from 1 January 2016.

Comments

The main concerns raised during the drafting of the rules in respect of real estate investments was that the proposed 25% capital requirement for insurance companies investing in real estate is too high and a 15% pan-European capital charge would be more realistic, with the possibility of a +/-10% dampener.

Despite heavy lobbying,this concern was not addressed, and the impact on the industry remains to be seen.

SENIOR MANAGERS REGIME

It has now been announced that the Senior Managers Regime will apply to all Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) regulated firms in the future.

Timing

The new regime will initially apply to UK banks and investment banks from 7 March 2016.

There is an expected extension to all FCA/PRA regulated firms during 2018.

Comments

The new regime will focus on significant management functions, meaning that firms will need to allocate key responsibilities clearly amongst members of staff. Firms will need to provide the FCA and/or the PRA with statements of responsibility for their staff and these will be used by the regulators to assess individual accountability in the case of breaches. There is also a requirement for firms to assess the fitness and propriety of their staff on a continuing basis.

The much feared 'reverse burden of proof' for senior managers has now been dropped, as of October 2015. This may come as a relief to many firms and senior managers, but it does not mean that the regulatory stance on senior manager accountability will be much softer. The 2018 date is not yet certain and there is a good amount of time for non-banking firms to get comfortable with the new regime whilst it applies to banks and investment banks from March 2016.

PRIVATE EQUITY REAL ESTATE FUNDS UNDER INCREASED SECURITIES AND EXCHANGE COMMISSION (SEC) SCRUTINY

In May 2015, officials of SEC in the US announced that the Private Funds Unit (PFU) would begin scrutinising private equity real estate fund practices. In particular, the SEC plans to review fund practices concerning real estate advisory fees, expenses and expense allocation; valuation; co-investment allocation; and disclosure to investors. The SEC's aim, according to Marc Wyatt, Acting Director of the Office of Compliance Inspections and Examinations, is to make certain that private equity real estate funds 'fully and fairly describe 'the deal' to investors, including discussing in a meaningful way how expenses will be assessed and fees will be collected.'

Timing

Immediate effect from May 2015.

Comments

Real estate fund managers with US investors or other jurisdictional ties to the US should review their fees, expense allocations, valuation methodologies, co-investment allocations and offering disclosures and confirm that none of these break SEC rules.

Managers should make sure that:

- fees charged for services provided by affiliated real estate advisors and employees are disclosed to investors;
- expenses are allocated to the appropriate fund vehicle;
- valuation methodologies and performance advertising are consistent with disclosures given to investors; and
- preferential co-investment rights are adequately disclosed to investors in the offering documents.

EUROPEAN LONG TERM INVESTMENT FUNDS (ELTIF) REGULATION

This is an extra level of regulation, on top of AIFMD, for managers of alternative investment funds (AIFs) that wish to market funds as ELTIFs.

The key advantage of being able to market a fund as an ELTIF is that, unlike other AIFs, ELTIFs can be marketed to certain retail investors (the minimum investment is €10,000, which must not be more than 10% of an investor's portfolio, so only investors with a portfolio size of €100,000 or more can in practice participate).

As this is a policy-driven initiative (drawing private, non-bank finance into companies and projects that require long-term capital, as a means of stimulating growth in the EU economy), there are restrictions on the type of investments ELTIFs can make.

As retail investors are involved, there are also further investor protections including restrictions on how marketing is carried out.

Timing

The ELTIF Regulation applies from 9 December 2015.

Comments

Real estate assets were not initially included but following lobbying have been, but only where there is a social benefit.

It remains unclear whether ELTIFs will become a popular choice for real estate fund managers and investors. This essentially depends on whether access to retail investors (for whom there is a relatively high bar in terms of personal wealth available for investment) will compensate for the cost of compliance with extra regulation on top of AIFMD (including under UCTIS V and the Prospectus Directive).

If this cost-benefit analysis favours the growth of ELTIFs, the vehicle may then encourage the trend towards local authority pension fund teaming up with each other to access illiquid assets, particularly infrastructure.

NEW PRIVATE FUND LIMITED PARTNERSHIP PROPOSALS IN THE UK

The Government is proposing to modernise the UK limited partnership regime, which has not been amended since 1907. The aim is to boost the UK's dominance as a fund domicile by bringing the UK limited partnership vehicle in line with those of other jurisdictions.

The proposed changes would apply only to 'private fund limited partnerships' (essentially those that are collective investment schemes and elect to join the regime) and would include:

- **the creation of a statutory 'white list' of essentially strategic decision-making activities that limited partners would be expressly able to undertake without jeopardising their limited liability status;**
- **relaxation of the rules to allow more flexibility around capital structures, which would allow limited partnerships to abandon the current loan/capital split structure; and**
- **various administrative improvements including in relation to winding-up and transfers.**

Timing

The consultation closed on 5 October 2015. The Government is analysing responses and an announcement is expected during the first half of 2016.

Comments

The proposed route to the statute book is via a streamlined legislative process that permits minor changes to the law where the purpose is to remove uncertainty or administrative burdens. Substantial change to the law, such as making single legal personality available to UK limited partnerships, is therefore not on the cards. Nevertheless the proposals if passed would on the whole constitute a welcome update to the UK limited partnership regime, making it clearer, more flexible and more competitive.

It is likely that most private equity real estate funds structured as UK limited partnerships will be able to opt in to the new private fund limited partnership regime.

However, if the proposals are enacted as drafted in the consultation paper, not all real estate joint ventures will be allowed to avail themselves. This will depend on how individual structures are treated for the purposes of section 235 of the Financial Services and Markets Act 2000.

The responses to the consultation from key real estate industry bodies (including AREF, BPF, INREV and IPF), whilst broadly supportive, suggested some minor changes that would iron out some technical points and ensure that the new regime is available to all real estate limited partnership investment vehicles that should benefit.

We await the final form legislation.

Legal developments – IT (data protection, cyber security and technology)

GENERAL DATA PROTECTION REGULATION	**The draft General Data Protection Regulation (the Regulation) was initially published by the European Commission in 2012. It is now proceeding along the legislative path towards adoption.**	**Timing** The Regulation has to undergo two processes: 1) agreement between the Commission, Parliament and the Council (which involves negotiations conducted in secret); and 2) approval by the Commission's body of lawyer linguists. The Regulation should be law before the end of 2016.	**Comments** Principal new features to look out for are: • increased fines for breach (as a proportion of worldwide turnover, though the final proportions limits have not been agreed); • there will be much greater scope for one stop shopping, so that you only need deal with one information regulator for the whole of the European Union; and • where the 'consent' of the data subject is required or needed then the rules on what constitutes consent are likely to be stricter. Real estate businesses should be aware of the position concerning consent – it is worth writing down the sorts of things you want to do with names, addresses, telephone numbers and financial instrument details and then seeking express consent from your clients accordingly.
EXPORTING PERSONAL DATA TO THE US	**The Schrems case has made exporting data to the US very difficult or risky.**	**Timing** Unless you are based or dealing in northern Germany it is unlikely that you will be in any difficulties until the end of January 2016. After that this is likely to be a serious issue.	**Comments** This case effectively made data transfers to the US illegal and none of the alternatives appear to offer a completely risk-free workaround. The European Commission is working frantically to solve the problem but in the meantime you should look at your personal data flows in order to check that either there are no flows to the US or that if there are then they are not susceptible to US government surveillance.
DIGITAL SINGLE MARKET	**The European Commission has announced its Digital Single Market Strategy (the Strategy) for Europe.** **The focus is on three areas:** **1) better access for customers and businesses to digital goods and services;** **2) shaping the environment for digital networks and services to flourish; and** **3) creating a European Digital Economy and Society with long-term growth potential.**	**Timing** On 24 September 2015, the EC launched two public consultations relating to the Strategy, the first in relation to geo-blocking and other forms of geographically-based restrictions, and the second on the role of and regulatory environment for online platforms.	**Comments** The development of the strategy may be of concern to traditional bricks and mortar retailers given the objective to facilitate the move to digital business.However, it may provide opportunities for the growing Click & Collect retail model, possibly edging retailers towards smaller centre-of-town premises largely operating as collection points
WEBSITE TERMS AND CONDITIONS – EUROPEAN COURT OF JUSTICE (ECJ) DECISION	**The ECJ has ruled that the method of accepting general terms and conditions of a contract for sale on a website by clicking a link complies with the formal requirements for jurisdiction agreements under Article 23 of the 2001 Brussels Regulation, regardless of whether a terms and conditions page launches automatically (El Majdoub v CarsOnTheWeb Deutschland GmbH).**	**Timing** Applicable now.	**Comments** This affects any real estate investment business that is conducted online, by clarifying how website terms and conditions should be displayed.

REAL ESTATE FINANCE GROUP REPORT – A VISION FOR REAL ESTATE FINANCE IN THE UK

In October 2013 the Real Estate Finance Group (REFG), a cross-industry group of senior real estate professionals, published a report entitled A Vision for Real Estate Finance in the UK (the Report). This aimed to help market participants to better withstand the cyclical nature of the market and survive the next real estate finance boom and bust.

The Report outlined seven proposals for the real estate finance market in an attempt to learn from the mistakes of the past:

- **Commercial real estate (CRE) loan database**
- **Expertise and insight for the regulator**
- **CRE finance qualifications**
- **Use of long-term measures for risk management (capital requirements linked to a property's long-term LTV)**
- **Better risk differentiation in regulatory capital requirements**
- **Encouraging diversity (variety of types of lender)**
- **Regulatory governors, not switches, operating consistently across the cycle (automated intervention based on market data)**

Timing

The Report was published in October 2013 and incited discussion and debate.

REFG received considered and some very detailed responses on the proposals outlined in the Report from across the sector, which it incorporated into its final report in May 2014.

The proposals are now with the Property Industry Alliance (PIA) Debt Group, which will focus on three of the Report's proposals: the CRE database, the long-term value metrics and the CRE finance qualification.

Comments

Whilst some of the proposals contained in the Report have been met with criticism, others have been well received.

The Bank of England has confirmed that it will work alongside the UK real estate finance industry to build a commercial property loan database.

In a recent dinner with professionals from the real estate finance industry, Alex Brazier, a member of the BoE's financial policy committee, outlined the Bank of England's support for two of the seven REFG proposals, namely creating a database of CRE loans and the adoption of 'through-the-cycle' property valuations in order to capture a property's long-term LTV.

Mr Brazier said that the industry proposal was 'music to our ears' and that it is counter cyclical, mirroring the way capital requirements for banks will now operate.

In the first instance, implementation of the proposals will be sought without the need for primary legislation

EUROPEAN MARKET INFRASTRUCTURE REGULATIONS (EMIR – OTC DERIVATIVES)

EMIR is the EU's implementation of the G20 mandate, addressing the risks of over-the-counter (OTC) derivatives and making the OTC derivatives markets more transparent.

EMIR impacts on all users of OTC derivatives to a greater or lesser extent, depending on whether a user is a financial counterparty or non-financial counterparty (NFC). It imposes three key requirements:

1) **a central clearing requirement (requiring OTC derivatives to be cleared through a 'central clearing counterparty' or CCP);**
2) **a reporting requirement (requiring users of OTC derivatives to report information about them to a repository of information known as a 'trade repository'); and**
3) **a risk management requirement (requiring users of OTC derivatives to manage risks relating to them).**

Financial Counterparties – Real Estate Funds

Real estate funds, such as those regulated under AIFMD, will generally be considered alternative investment funds and will therefore be financial counterparties subject to all mandatory clearing, reporting and risk management requirements.

NFCs – Direct Real Estate Investments

EMIR divides NFCs into two groups: counterparties whose trading exceeds the EMIR clearing threshold, and those whose trading falls below the clearing threshold. The latter will only need to comply with the reporting requirement.

Most real estate investors trade OTC derivatives (usually interest rate swaps) on a very irregular basis for the purpose of proper risk management. Recital 29 to EMIR recognises that NFCs may use OTC derivatives to hedge commercial risks linked to their commercial or treasury financing activities, and that trades entered into for hedging purposes should not count towards the clearing threshold. Therefore most property investors will be NFCs whose trading falls below the clearing threshold.

Timing

16 August 2012: EMIR came into force, but most provisions only apply after technical standards come into force.

15 March 2013: The technical standards on OTC Derivatives, Reporting to Trade Repositories and Requirements for Trade Repositories and Central Counterparties entered into force.

12 February 2014: Details of all classes of derivative contract (both OTC and exchange traded derivatives (ETD)) are required to be reported to recognised trade repositories.

11 August 2014: Financial counterparties/NFCs are required to provide daily reports on mark-to-market valuations of positions and on collateral value.

1 September 2016: Variation margining requirements for non-centrally cleared trades will apply for the largest institutions.

1 March 2017: Variation margining requirements for non-centrally cleared trades will apply for all other institutions that are within scope.

1 September 2016 – 1 September 2020: Initial margining requirements for non-centrally cleared trades will apply from 1 September 2016 for the largest institutions. This will be followed by an annual phasing-in such that all other institutions that are within scope above a minimum threshold will be subject to initial margin from 1 September 2020.

Implementation dates are subject to change depending on the progress of EU implementation.

Comments

Based on the scope of EMIR, various industry bodies felt that the reporting requirement is the issue of most concern.

It is felt that EMIR is placing a 'disproportionate operational and legal burden' on real estate investors NFCs, by requiring them to report details of their derivatives to the trade repositories (TRs) even when these details are already reported by their bank counterparty.

Currently, NFCs have to check that information by registering with one or more TRs and navigating their information systems, which can be extremely complex. This comes at a disproportionate financial and administrative cost, particularly for smaller, occasional users of derivatives.

The industry has responded to the EC's consultation on unintended consequences of EMIR by suggesting a 'single-sided reporting' system. Under such a system, only one party would be required to report trade information and would retain legal responsibility for doing so.

If the EC decides that a single-sided reporting is not appropriate, the alternative would be for the EC to consider providing an exemption to the trade reporting requirement for NFCs, or at least make reporting data more freely available so that businesses can check the accuracy of the data that has been reported on their behalf.

Legal developments – residential landlords

NEW RULES ON DEPOSIT PROCEDURE	**The Deregulation Act 2015 has significantly changed the procedure in relation to deposits. This is important for landlords and agents.** **Since 6 April 2007, a landlord of an assured shorthold tenancy (AST) has had an obligation to place a tenant's deposit into an authorised Tenancy Deposit Scheme, when the tenancy begins.** **Now, if the rules on deposits have not been followed, and certain prescribed information has not been served on the tenant, the landlord will not be able to take possession of the property. Different rules apply, depending on whether the deposit was received before or after 6 April 2007.**	**Timing** The Deregulation Act came into force on 26 March 2015.	**Comments** The changes to the tenancy procedure were designed to codify recent case law on deposits. However, the provisions of the Deregulation Act 2015 are complex and will affect both landlords and agents. Failure to follow the rules means that the landlord cannot serve a section 21 notice to bring the tenancy to an end. In addition, the landlord could be liable to pay a financial penalty of up to three times the amount of the deposit.
TERMINATION OF ASSURED SHORTHOLD TENANCIES (ASTS)	**The Assured Shorthold Tenancy Notices and Prescribed Requirements (England) Regulations 2015 and further provisions of the Deregulation Act 2015 have made changes to the procedure for terminating an assured shorthold tenancy (retaliatory evictions).**	**Timing** The Regulations and the Act came into force on 1 October 2015.	**Comments** Both the Regulations and the Act affect whether or not a landlord can serve a section 21 notice seeking possession of a dwelling let on an AST in England. The new provisions are designed to prevent so-called 'retaliatory evictions' where a tenancy is terminated after the tenant has complained about the condition of the premises.
FIRE SAFETY EQUIPMENT	**The Smoke and Carbon Monoxide Alarm (England) Regulations 2015 have been introduced to ensure that premises let in England for residential purposes are safe for their inhabitants.** **With some exceptions the requirement is for the landlord to install smoke alarms on each storey of premises that are used as living accommodation and where there are solid fuel burning appliances, there must be a carbon monoxide detector in the same room too. These detectors must be in working order at the start of the tenancy.** **As yet, there is no definition of what constitutes a smoke or carbon monoxide alarm by reference to a British Standard.**	**Timing** In force as of 1 October 2015.	**Comments** This is another health and safety requirement with which landlords of residential properties must comply. Local housing authorities have the ability to enforce these regulations and, since the Legal Aid, Sentencing and Punishment of Offenders Act 2012 which removed the £5,000 upper limit on fines imposed in the magistrates' courts, can impose unlimited fines.
RIGHT TO RENT – IMMIGRATION ACT 2014	**All private landlords in England will have to check that new tenants have the legal right to live in the UK before renting out their property. This is known as the 'right to rent'.** **Under the Immigration Act 2014 landlords of residential properties must check the immigration status of prospective tenants (and other occupiers) before allowing them to rent property. Failure to comply risks a significant fine.**	**Timing** This already applies to a pilot area in the West Midlands. The Government intends that this be rolled out to the whole of England from 1 February 2016.	**Comments** Landlords should ask all tenants to provide the relevant ID documentation, to avoid a situation where they are accused of discrimination (which comes with its own penalties if proven). Landlords who own a property in the pilot area in the West Midlands should already be carrying out the relevant right to rent checks. Landlords in other areas should be putting appropriate systems in place now so that they are ready for the proposed roll-out in February 2016. The Government has published guidance for landlords and letting agents, to help them comply.

Legal developments – insolvency

FORFEITING A LEASE OF A TENANT IN ADMINISTRATION

A court has given a landlord permission to forfeit a lease where the tenant was in administration (the Strada case).

The landlord's application was granted because:

- **the proposed assignee was not an appropriate replacement tenant, as it had no covenant strength; and**
- **it was realistic for the landlord to find a replacement tenant, with good covenant strength and paying an increased rent.**

Timing

Judgment was given on 14 September 2015.

Comments

This decision gives hope to landlords that they might be able to forfeit a lease where a tenant is in financial difficulty, even where there has been a pre-pack sale, because administrators cannot assume that:

- the landlord will always be prevented from forfeiting as a result of a moratorium; nor that
- they can present a landlord with a pre-pack replacement tenant and 'strong arm' them to agree to an assignment.

CHANGES TO 'PRE-PACKS' PROCEDURE (SIP 16)

A revised Statement of Insolvency Practice 16 (SIP 16), issued by the Joint Insolvency Committee, has reformed the procedure for pre-packaged sales (known as pre-packs).

The revised SIP 16 promises greater transparency and reassurance for creditors in pre-pack sales, in particular:

- **IPs will have to follow a guide for marketing the property (or explain why they have not done so);**
- **any valuations must be carried out by an independent valuer; and**
- **the IP must disclose all information relating to the pre-pack before the administrators are appointed and through the entire transaction**

Timing

Effective from 1 November 2015.

Comments

Pre-packs have attracted critics, who allege that the process suffers from a lack of transparency and allows the company's directors to set up as a new corporate entity, while leaving the old liabilities behind. This led to a feeling that businesses and assets of insolvent companies were not being properly marketed and creditors were being left out of pocket.

The report's most interesting aspect is the formation of a 'pre-pack pool' whose function would be to police pre-pack sales to 'connected' parties – these are sales to companies where the existing management or shareholders are involved.

The 'pre-pack pool' is a completely new idea involving a committee or 'pool' of reviewers, who will monitor sales to connected parties. Where the IP is proposing a pre-pack sale to a connected party, the connected party should approach the 'pre-pack pool' on a voluntary basis for an opinion on the transaction. A negative opinion does not stop the transaction, but the IP will have to disclose whether the pool was approached and whether a negative or positive opinion was given.

The new guidelines are still voluntary and there is some flexibility for insolvency practitioners in implementing the measures, as long as any non-compliance is justified. However, the Government has made it clear that if the industry does not adopt these measures, legislation will be implemented, which may ban pre-packs sales to connected parties altogether.

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PAUL MITCHELL
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New research undertaken for the IPF's 2011-2015 Research Programme provides investors with insights on how risk in individual properties should be priced, on the structuring of property portfolios, and for investment processes and strategies in general.

The analysis draws on the detailed records of 1,000 UK properties held by eight big investors since 2002 and on case studies of 88 of these properties.

Specific risk & systemic risk

The approach distinguishes between specific risk in individual properties and systematic risk. Specific risk is unique to the asset and independent from one property to another and hence is a risk which, when combined with other assets in a portfolio, can be diversified away. The primary concern of the investor therefore is to have enough assets in the portfolio to diversify away this specific risk. In this respect, the research not only considers how many properties are required to diversify a portfolio – thereby updating research undertaken for the IPF in the mid-2000s – but also assesses how different property characteristics affect portfolio risk.

By contrast, systematic risk relates to the tendency for individual properties to move together and to be exposed to driver of this correlation. Such risk is inescapable, being part and parcel of investing in a risky asset class. In contrast to specific risk, the primary concern of the investor is to get a premium return (i.e. a risk premium) in order to compensate for this inescapable risk. In this respect, the report identifies the most important characteristics varying systematic risk in individual properties.

The 'market' is often perceived to be the main systematic risk. The research confirms that the market – represented by IPD segments such as City of London offices, shopping centres, South Eastern industrials etc. – is the predominant risk in most UK commercial properties.

Whilst this risk in most properties is proportionate to the market (as illustrated in Figure 1), the research also finds that some properties have either accentuated or dampened sensitivities to changes in the market's return – they are correspondingly high or low 'beta' properties (Figure 2 portrays a high beta property). To ensure that their returns are commensurate with this accentuated (or dampened) risk, such properties need to be priced with a higher (or lower) risk premium than the market average.

By contrast, specific risk (that remaining after accounting for systematic risk) for most properties tends to be low; the property in Figure 1 is an example. Large numbers of tenants, low yields, and relatively long unexpired lease terms all keep specific risk in individual properties on the low side. The implications for portfolio construction are outlined later.

Figure 1: **Unit beta property – systematic risk same as market**

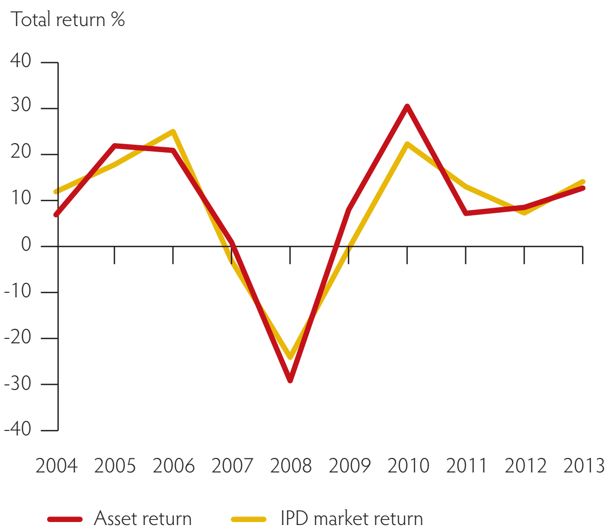
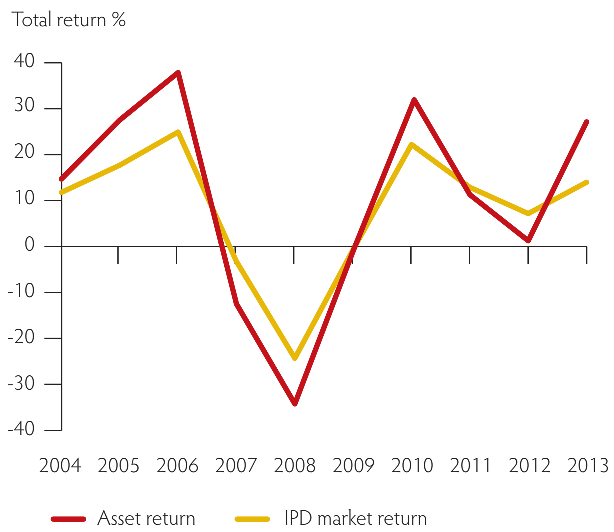


Figure 2: **High beta property – systematic risk 1.5x the market**



A minority of properties, however, have high levels of specific risk. In most cases, such risk was found to be persistently high but in about a quarter of high specific risk properties it largely reflected a one-off event. Examples of these two types of property are illustrated in Figures 3 and 4 respectively.

Figure 3: **Property with persistently high specific risk**

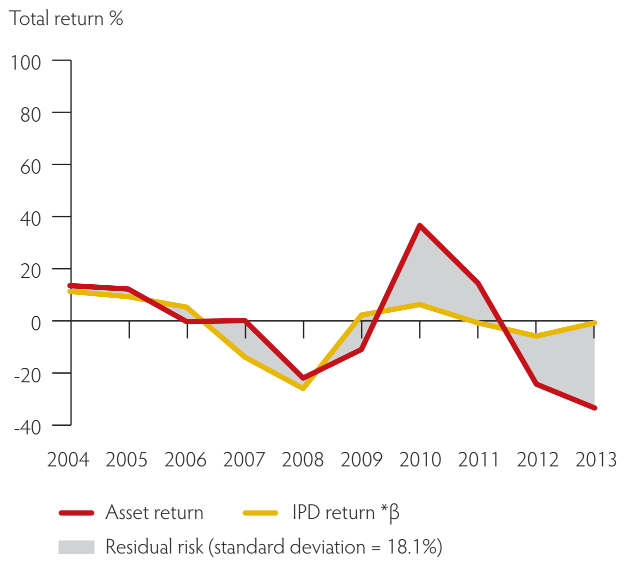
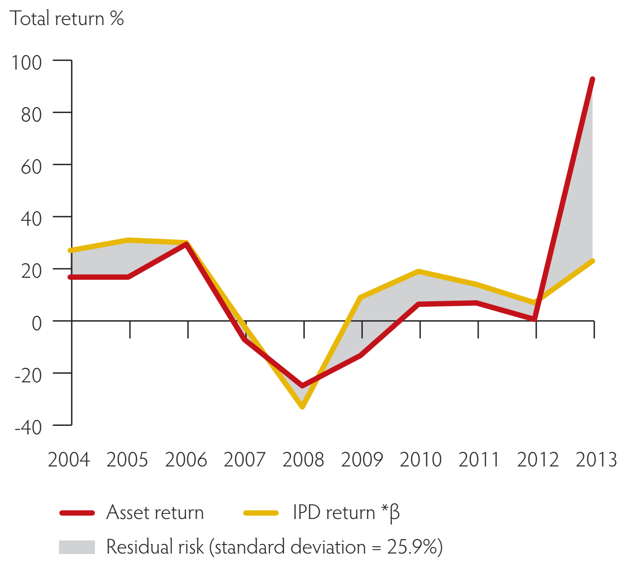


Figure 4: **Property with high one-off specific risk**

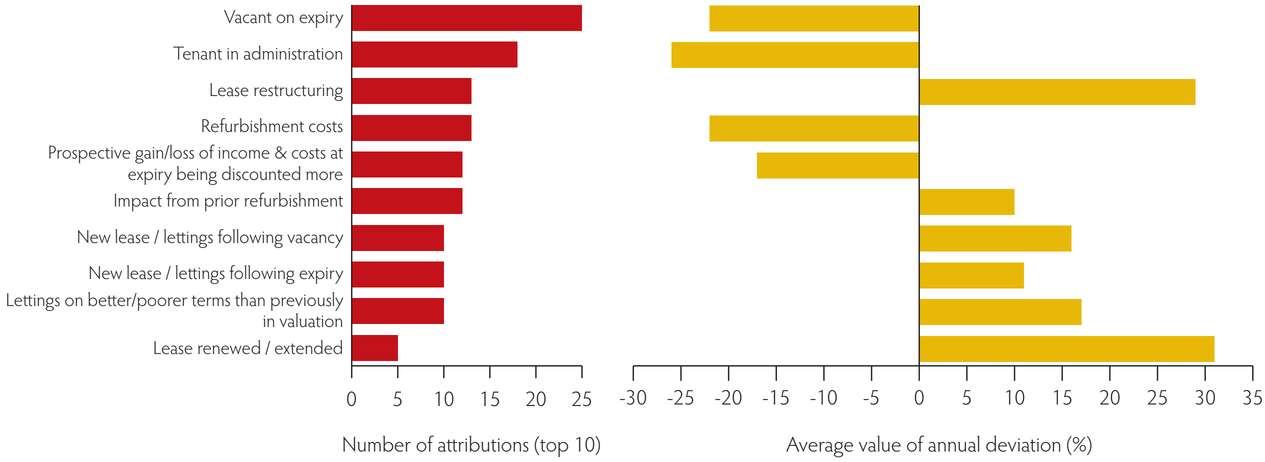


Sources of specific risk

The case studies (see Figure 5) indicate the most common sources of high specific risk are associated with 'lease events' – in particular, vacancies at the end of a lease, tenants falling into bankruptcy and so on. Furthermore, there is a tendency for investors to start pricing prospective lease events (for example, what is expected to happen on and after a lease expiry) very cautiously to the extent that the actual outcomes on average represent pleasant upside surprises. This creates volatility (risk) before and after the lease event, compounding the direct impact of the event.

The second largest source of high specific risk in UK commercial properties is associated with asset management. This involves a variety of activities, from the defensive refurbishment of a property in order to make it more lettable to more opportunistic activities such as re-configuring space to make it more efficient, engineering a change of use through the local government planning process, and the re-gearing of leases.

Figure 5: **Case study evidence – attribution and average magnitude of high specific risk in individual properties**



In the same way that volatile sentiment accentuates the direct impact of lease events, refurbishment activity tends to generate big downside swings in performance when being undertaken but significant upside once successfully completed.

Whilst the timing of these trains of events varies from property to property (being dependent on their own lease cycles), meaning that they represent a form of specific risk, the impact also seems to be accentuated by the market cycle. Those properties most exposed to high refurbishment expenditure and to the letting market tend to have relatively high market sensitivities (betas).

In general, properties with high capital values relative to their market segment and with relatively small numbers of tenants, high yields and short unexpired lease terms tend to have above average market sensitivities and vice-versa.

In other asset classes, the realisation that there are systematic drivers other than and independent of the market (i.e. simple beta) has led to the development of 'factor' (or style) based investment strategies, for example a bias towards or focus on 'value' rather than 'growth', which reflects the belief stocks with either of these characteristics behave differently over the cycle to the average stock.

The IPF research, however, suggests that few commercial properties are systematically affected by factors such as yield, size, quality etc. The reason appears to be that individual properties have more significant idiosyncrasies that overwhelm these relatively small factor influences. Lots of properties are therefore required to get an exposure to such factors, making implementation difficult.

This also applies to the influence of town, which is rarely a significant influence on a property's performance. Picking a favourably performing town is no guarantee that the property will perform well, large numbers of assets are required to achieve such performance. This raises questions on the efficacy of town forecasting.

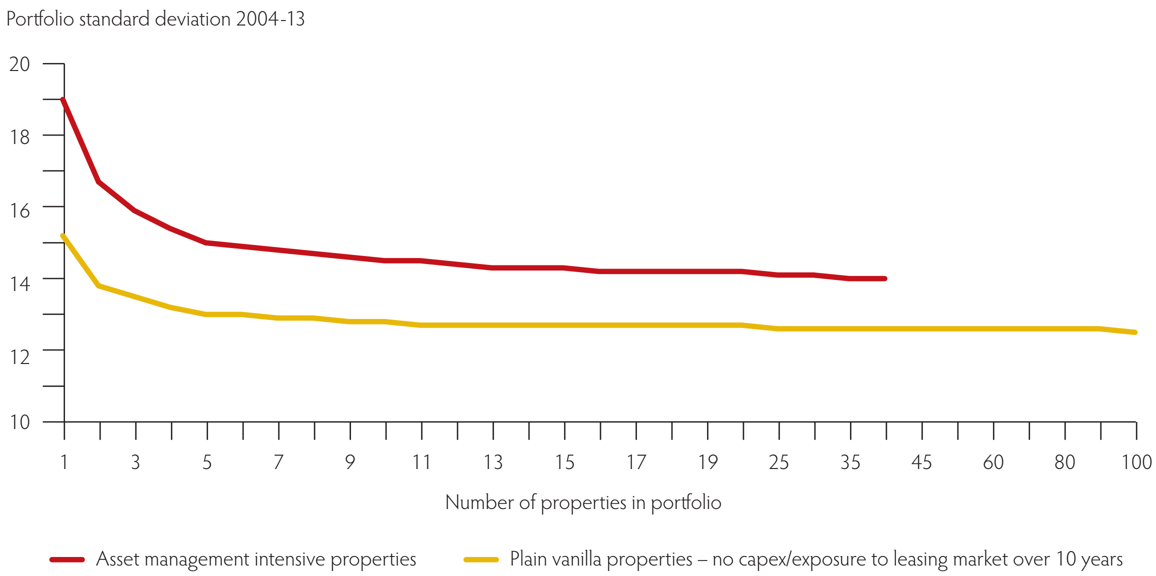
Implications for investors

What are the implications of this research for investors? First, risk in individual properties needs to be priced more systematically and with a greater range than in the past. Those types of property with high beta (for example, properties frequently exposed to the letting market and with high refurbishment needs) on average have historically delivered relatively poor risk-adjusted returns (i.e. negative alpha), whilst large properties and those infrequently exposed to the letting market have tended to experience significant alpha. In particular, high beta properties should be priced with a greater risk premium than in the past with low beta ones priced with a lower risk premium than historically.

There are also lessons for portfolio structuring and risk control. Over the 10 years to 2013, diversification of portfolios made up of 'plain vanilla' properties – those with relatively low exposure to capital spending and the letting market and with 'slightly better than average' characteristics in terms of lot size and number of tenants – could be achieved with very few properties, as Figure 6 shows; portfolio risk is also low.

By contrast, properties frequently exposed to the letting market and to relatively high capital expenditure – labelled in the report as 'asset management intensive' – have relatively high levels of portfolio risk regardless of the number of properties. Notably, this distinction generates much larger divergences in portfolio risk than other characteristics such as high and low yield, short lease and long lease etc. Those investing in such properties need to diversify to keep portfolio risk down but, because of the high betas in the underlying properties, can never avoid relatively high levels of risk.

Figure 6: **10-year standard deviation of simulated portfolios by type of property***



**Average of 1,000 simulated portfolios (using 2004-13 individual property data)*

The third lesson is the factor-based investment strategies that have become popular in the equity market are unlikely to take off in real estate. The exception might be those based on unique property characteristics such as asset management intensity and its converse.

Finally, investors should be concerned more with structuring property portfolios on the basis of exposure to lease events and the need for intensive active management than on the traditional basis of geography because these issues make a bigger difference to a property's performance and risk profile.

UK Development Finance in 2015

KATE GIMBLETT
KG Consulting & Research

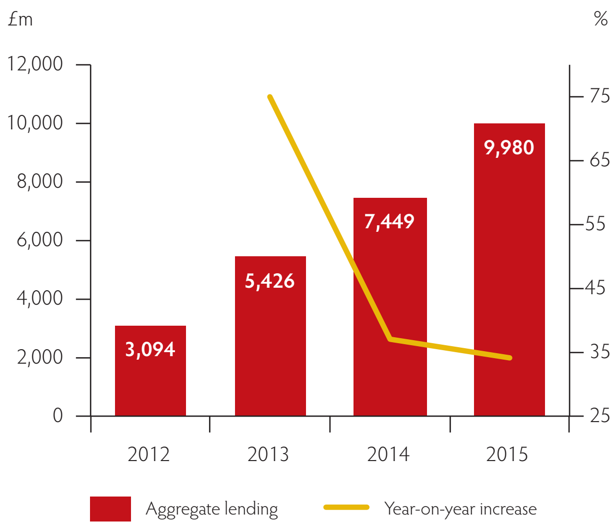
UK development finance originations collapsed in 2008 as a result of the financial crisis. Thereafter, a view was widely held even as recently as 2014 that only limited development lending activity had resumed. Survey evidence gathered during the first half of 2015 for the IPF UK Development Finance Review[1] shows that the above market perception did not reflect the underlying market reality.

There has been a notable increase in the availability of development finance since the previous IPF Short Paper on this subject was published in October 2011. That research found that only 11 of the lenders surveyed had completed a UK development loan transaction during the first three quarters of 2011 and only 16 lenders had been working on transactions. There are now a wide variety of lenders targeting the UK development finance market including a growing phalanx of new entrants.

Overview

For the 2015 research, 79 real estate lenders were contacted in total. Of those, the majority still did not count development finance as one of their core lines of business and many did not engage in this type of lending at all. However, the 35 active development lenders surveyed in H1 2015 reported they had increased their annual development lending by over 140% during the period 2012-14 (see Figure 1) and they were collectively aiming to increase their lending by a further 34% from approximately £7.5bn in 2014 to around £10bn by the end of 2015. The big step increase in development finance provision actually occurred in 2012-13 when transactions increased by 75% in value. Annual growth by value has since increased at around half that rate but from a much higher base, reflecting a much more competitive lending market.

Figure 1: **Aggregate lending (All lenders)**



Pre-2007, development finance in the UK was dominated by banks. However, on the basis of this 2015 research sample, the banks' overall dominance has been severely eroded by the increasing prominence of the alternative lenders (often misleadingly called 'shadow banks'). These lenders include debt funds and alternative non-bank lending platforms deploying professional or institutional money.

1 **UK Development Finance Review 2015**, IPF Short Paper 27, published by the IPF Research Programme in September 2015.

The banks (both UK and non-UK) continue to dominate the market for senior lending on pre-let and pre-sold developments. However, developers seeking higher leverage or loans for speculative developments are now more likely to succeed in securing finance through the debt funds and alternative lending platforms (although some banks do offer stretched senior loans and source mezzanine).

Banks

Most UK banks are willing to finance developments anywhere in the UK provided it is for the right sponsor with the right scheme in the right place. This survey sample indicated UK banks' development finance provision will have increased in 2015 by approximately 13% to around £4.55bn by the end of the year. Indeed, this could prove to be an under-estimate of the final total given the momentum described by some survey participants.

A small number of UK clearing banks continue to provide a nationwide presence across a wide spectrum of loan sizes and asset types. However, when asked about minimum and maximum loan sizes, only a few banks were prepared to contemplate undertaking small property development loans (sub £5m). In contrast, all lenders will go up to £100m and the majority will exceed that level for the right developer client with an excellent project, provided that sponsor is within appropriate exposure limits.

Turning to non-UK banks, these tend to focus on larger transactions with well-known sponsors when lending in the UK. They set their minimum loan sizes at a commensurately higher level than the majority of the UK banks and transactions of under £20m are not generally undertaken.

The non-UK banks were previously more 'London-centric' than their UK bank counterparts and the overwhelming majority only financed deals in London and the South East during the period 2012-14. However, that strategy changed in 2015 and the number that will consider financing regional developments has quadrupled in the past year. The majority of non-UK banks say they will be client-led and if a sponsor wants to carry out a project outside of London, they are prepared to evaluate the proposition.

Non-UK banks' lending for development has increased at a much steeper rate than UK bank lending, albeit from a lower base. They tend to focus on financing office, retail and mixed-use developments but many are open to financing assets of other types. Those surveyed collectively hope to have increased their development lending by over 70% to around £1.55bn by end-2015.

Regardless of domicile, every bank wants their developer clients to have substantial experience and an excellent track record. Most also want the prospect of a long term relationship and cross-selling opportunities that generally arise with developers of size. Unfortunately, this leaves the small developer underserved by the market with only a handful of UK clearers and alternative platforms that will lend to them.

One of the few funding sources that cater specifically for the small developer seeking loans of under £5m is the new 'fintech' sector of peer-to-peer lending platforms, but their current provision is small (under £100m). These platforms are staffed primarily by former property bankers so even here the SME developer without a spotless track record is unlikely to be offered access to finance.

Pricing for pre-let and pre-sold senior UK development loans

Loan to cost ratios (LTCs) and loan to value ratios (LTVs or loan to gross development value) offered by banks have only moved up by a relatively modest 5% since 2011. This has been one of the key factors in the rise of the alternative lenders who are able to offer higher leverage.

However, a more startling change has occurred in banks' margins. Quotes for the top end of the average margin range have fallen by 135 basis points since 2011, which is substantive evidence of increasing competitive pressure. Figure 2 shows the ranges in LTC, LTV and average margins identified by the research.

The banks' lending margins for residential development loans are notably higher (50-65 basis points on average) than for commercial development – see Figure 3. This stands in sharp contrast to the alternative lenders who generally prefer residential loan exposures and price them more keenly than commercial development loans.

LTCs offered by UK and non-UK banks are in the 50%-70% range and average margins were in the 245-315 basis point range over LIBOR at the time of the survey. However, it is often a challenge to compare all-in financing costs across lenders because of the variation in fees – see Figure 4. Many lenders with the lowest margins have higher fees or more fee types.

Non-UK banks have lower requirements for pre-lets and pre-sales than UK banks on non-speculative loans. This is attributable to differences in regulation. UK bank regulation has become more restrictive and regulatory capital has imposed additional costs on development lending – particularly on loans for speculative developments – since supervisory slotting was introduced by the UK regulators.

Figure 2: **Pre-let/pre-sold commercial senior development loans – all banks**

	UK & non-UK banks
LTC range (%)	50-70*
LTV or loan to GDV range (%)	40-65
Average margin range (bps)	245-315
Actual margin range (bps)	150-550

*One bank will go up to 75% LTC

Figure 3: **Pre-sold residential senior development loans – all banks**

	UK & non-UK banks
Actual LTC range (%)	50-70
Loan to GDV range (%)	40-65
Average margin range (bps)	295-380
Actual margin range (bps)	150-550

Figure 4: **Lending fees**

Banks' fees	Front end fees bps	Exit fees bps	Non-utilisation fees % of margin
Commercial	50-150	0-200	35-50
Residential	50-200	0-200	35-50

Alternative lenders

Non-bank alternative lenders are not subject to the regulatory costs imposed on banks. They are asset managers deploying their investors' equity and they operate diverse business models structured to meet investors' IRR expectations. Alternative lenders' IRR targets range from 7% to 20% and they aim to achieve their IRRs through a varied mixture of margin or coupon, fees, profit participation and other types of return participation.

The alternatives previously focused on schemes in London and the South East but they now lend in many UK regions. The majority target residential and residential-led mixed-use schemes but in aggregate these funds finance assets in all sectors.

The alternative lenders are very diverse in terms of the loan size they are willing to offer. For the majority who contributed to this research, the minimum loan size is in the £5m-£20m range but some platforms will make smaller loans. At the upper end of the scale, the alternatives can and already have delivered some of the very largest development finance transactions.

Alternative lenders dominate the markets for speculative lending that banks now largely avoid due to regulatory capital charges. They typically offer stretched senior loans or whole loans, mezzanine and some offer preferred equity as well.

Alternative lender pricing for whole loans and mezzanine

Given these lenders operate across a wide spectrum of risk and return, the range of risk profiles is reflected in the range of LTCs, margins or coupon rates, fees and fee structures that they will offer. These are described in Figure 5.

Figure 5: **Debt funds and alternatives – speculative stretched senior and whole loans**

	LTC range %	LTV/LGDV range %	
LTC and LTV	50-95*	50-80	
* High LTC loans require profit participation			
	Coupon rates %		
Residential coupon range	4.5-15		
Commercial coupon range	5.5-15		
Alternatives' fees	**Front end fees** bps	**Exit fees** bps	**Non-utilisation fees** % of margin
Commercial	100-250	100-300*	Varies widely
Residential	100-250	100-300*	Varies widely
* and/or profit participation			

The alternatives surveyed for this research collectively aspired to achieve a 50% increase in lending during 2015 to around £3.8bn but many were sceptical their competitors would achieve their growth targets without lowering their IRR hurdles. Since the main source of mezzanine finance is the alternatives, provision of higher leverage may see further expansion as alternative investors' hunt for yield takes them further up the risk curve to meet IRR expectations.

In summation, UK development finance has been on a growth trajectory since 2011 and access to finance has not been a problem for larger developers. The challenges to growth in development revealed during this research were far more apparent in non-finance spheres. Developers are finding it increasingly difficult to source sensibly priced sites, there are supply problems in construction materials, and there is a severe national shortage of experienced construction professionals at all levels.

UK Consensus Forecasts
November 2015

PAM CRADDOCK
IPF

Near-term forecasts have again firmed quarter-on-quarter, with a consensus of 13.8% for the All Property total return in 2015. Strong capital value growth prospects have been the principal contributor to this improvement, which is also reflected in the five-year average.

Rental value growth forecasts

The latest forecast returns reflect a further modest strengthening in sentiment across each year surveyed. For 2015, the expected average growth rate has improved by more than 30 bps since August. Although growth is predicted to decline over remaining years, the current averages for these periods are slightly higher than three months ago. As a result, the five-year average rental growth rate is projected to achieve 2.8% per annum.

Capital value growth forecasts

Whilst capital growth forecasts for 2015 and 2016 are virtually identical to those reported in August, averages have improved in each of the remaining three years of the survey period.

The increases to the 2017, 2018 and 2019 averages comprise rises of almost 30 bps, 35 bps and 45 bps (from 0.1%, 0.2% and -0.7%). As a result, the five-year average has continued its quarter-on-quarter improvement, rising to 2.6% per annum (from 2.1% in February).

Figure 1: **All Property rental value growth forecasts**

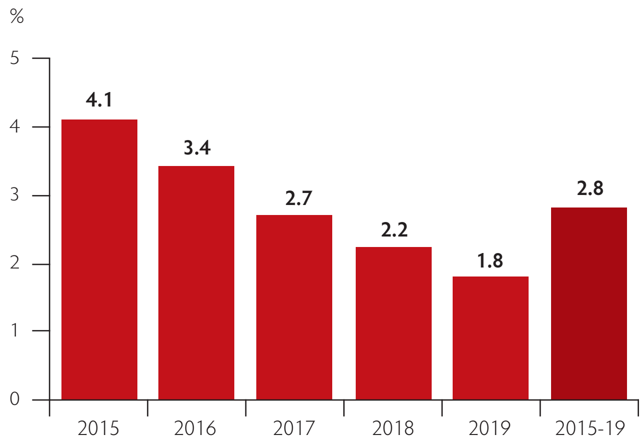
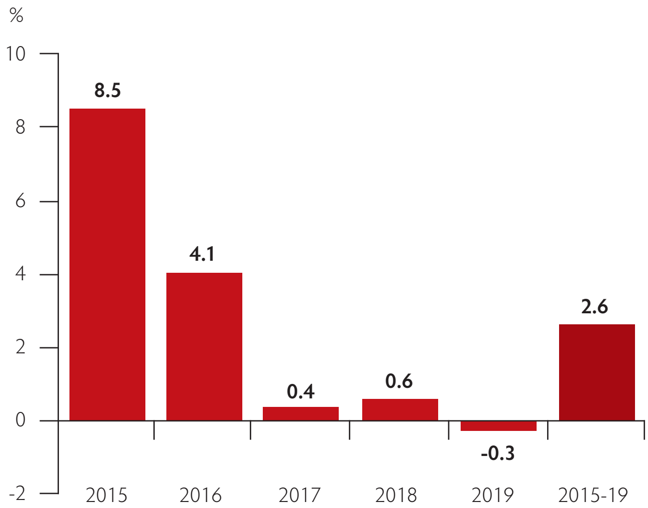


Figure 2: **All Property average capital value growth forecasts**

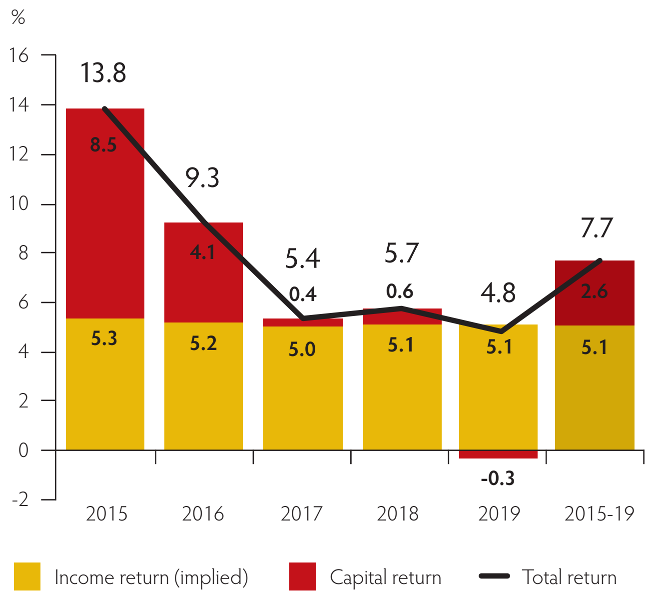


Total returns forecasts

The All Property total return forecasts for 2015 and 2016 are virtually unchanged since August, as rounding to one decimal place exaggerates the sub-5 bps changes to headline averages of 13.8% and 9.3% respectively.

Improved capital growth expectations in subsequent years, combined with marginally stronger implied income returns, lead to a modest improvements to the 2017 and 2018 averages, despite the promised EU referendum. As a consequence, the five-year average has risen by more than 0.25% to 7.7%.

Figure 3: **All Property total return forecasts**



Summary

Figure 4: **Property advisors and research consultancies**

	Rental value growth %			Capital value growth %			Total return %		
11 (12) contributors	2015	2016	2015-19	2015	2016	2015-19	2015	2016	2015-19
Maximum	4.8 (4.8)	4.7 (4.5)	3.5 (3.5)	9.4 (9.5)	7.2 (6.4)	4.8 (4.5)	14.9(15.0)	12.4(11.7)	9.8 (9.7)
Minimum	3.7 (3.3)	2.3 (2.3)	2.2 (2.2)	6.9 (6.9)	1.0 (1.0)	-1.1 (-1.1)	12.3(12.1)	7.0 (6.5)	4.9 (4.9)
Range	1.1 (1.5)	2.4 (2.2)	1.3 (1.3)	2.5 (2.6)	6.2 (5.4)	5.9 (5.6)	2.6 (2.8)	5.4 (5.2)	4.9 (4.8)
Median	4.3 (4.1)	3.8 (3.3)	3.0 (2.8)	8.4 (8.3)	4.5 4.2)	2.8 (2.8)	13.5(13.8)	10.0 (9.1)	7.8 (7.8)
Mean	**4.2 (4.1)**	**3.7 (3.4)**	**3.0 (2.9)**	**8.2 (8.1)**	**4.2 (4.0)**	**2.8 (2.7)**	**13.6(13.5)**	**9.5 (9.2)**	**8.1 (7.9)**

Figure 5: **Fund managers**

	Rental value growth %			Capital value growth %			Total return %		
13 (14) contributors	2015	2016	2015-19	2015	2016	2015-19	2015	2016	2015-19
Maximum	4.6 (4.3)	4.1 (4.7)	3.4 (3.7)	11.6(13.7)	6.0 (8.0)	4.3 (3.8)	16.3(18.3)	13.0(15.0)	9.1 (9.0)
Minimum	3.4 (2.3)	1.9 (1.7)	1.5 (1.3)	7.0 (2.5)	2.3 (-0.6)	0.7 (-0.3)	12.8 (9.4)	6.7 (4.3)	5.4 (4.6)
Range	1.3 (2.0)	2.2 (3.0)	2.0 (2.4)	4.6(11.2)	3.7 (8.6)	3.6 (4.1)	3.6 (8.8)	6.3(10.7)	3.7 (4.4)
Median	4.1 (3.3)	3.3 (3.1)	2.7 (2.6)	8.7 (7.7)	3.9 (4.3)	2.5 (2.2)	14.0(13.0)	8.6 (9.0)	7.0 (7.1)
Mean	**4.1 (3.3)**	**3.2 (3.1)**	**2.6 (2.5)**	**8.8 (7.6)**	**4.0 (3.8)**	**2.5 (2.0)**	**14.0(13.0)**	**9.1 (8.9)**	**7.3 (7.0)**

Figure 6: **All Property forecasters* – 26 (26) contributors**

	Rental value growth %			Capital value growth %			Total return %		
25 (26) contributors	2015	2016	2015-19	2015	2016	2015-19	2015	2016	2015-19
Maximum	4.8 (4.9)	4.7 (4.7)	3.5 (3.5)	11.6(13.4)	7.2 (6.4)	4.8 (4.5)	16.3(18.0)	13.0(13.0)	9.8 (9.7)
Minimum	3.4 (2.3)	1.9 (1.7)	1.5 (1.1)	6.9 (6.0)	1.0 (1.0)	-1.1 (-1.5)	12.3(11.5)	6.7 (6.2)	4.9 (3.4)
Range	1.4 (2.6)	2.8 (3.0)	2.0 (2.4)	4.7 (7.4)	6.2 (5.4)	5.9 (6.0)	4.0 (6.5)	6.3 (6.8)	4.9 (6.3)
Std. Dev.	0.3 (0.6)	0.7 (0.7)	0.5 (0.5)	1.1 (1.5)	1.4 (1.7)	1.3 (1.5)	1.0 (1.5)	1.6 (1.8)	1.3 (1.5)
Median	4.2 (3.8)	3.4 (3.3)	2.9 (2.8)	8.5 (8.5)	3.9 (4.1)	2.7 (2.7)	13.9(13.9)	9.1 (8.9)	7.4 (7.5)
Mean	**4.1 (3.8)**	**3.4 (3.3)**	**2.8 (2.7)**	**8.5 (8.5)**	**4.1 (4.1)**	**2.6 (2.4)**	**13.8(13.9)**	**9.3 (9.2)**	**7.7 (7.4)**

** Note one forecaster provided only rental forecasts at the All-Property level.*

IPF European Consensus Forecasts November 2015

PAM CRADDOCK
IPF

Contributors continue to demonstrate widely varying views on growth prospects both within and between the locations surveyed. Generally, growth in EU and, more particularly, eurozone countries (with the notable exceptions of Ireland and Spain) is still constrained by challenging economic conditions and structural issues.

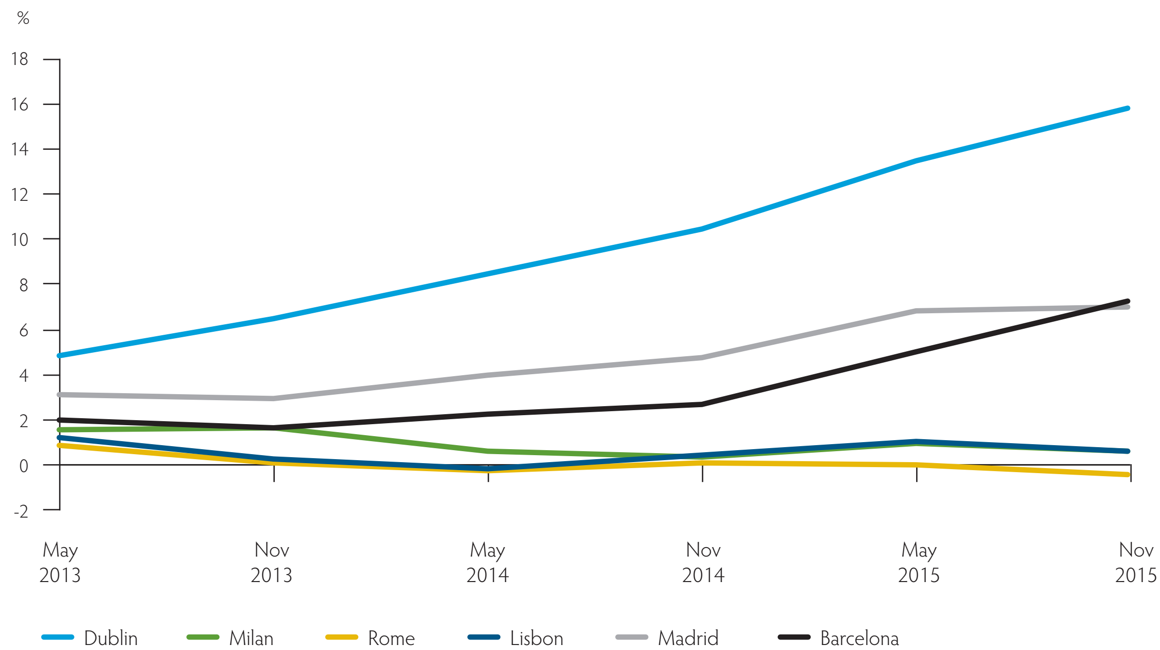
Current-year forecasts for Dublin and the two London markets sustain their rankings as leading growth markets but the prospects for both Madrid and Barcelona continue to strengthen and, whilst expected to peak in 2016, they are likely to be the best centres of growth in 2017 as well as over the five-year forecast horizon.

Outlook for 2015

PERIPHERAL MARKETS

Figure 1 shows further improvement in Irish and Spanish prospects. In the latter case, the tentative upswing in the economy is now starting to be reflected in the rental market, with an increase in the number of tenants looking to extend their premises or to relocate. The 2015 forecast for Dublin now stands at 15.8% with Barcelona at 7.3% (5.0% in May) and Madrid at 7.0% (previously 6.8%). Insufficient forecasts (fewer than five) were received for Athens to permit an analysis of this market.

Figure 1: **Weighted rental growth forecasts 2015 – peripheral eurozone economies**



Lisbon and Milan continue to show weak positive growth prospects of 0.6%, whilst Rome prime rents are expected to fall by 0.4% over the year.

REMAINDER OF THE EUROZONE

Probably the most liquid CEE market, Warsaw continues to experience downward pressure on rents with the construction of new offices set for double-digit growth in the near future. The current year's average forecast has fallen to -4.7% from -3.3% in May. Elsewhere in central and eastern Europe, the outlook for Prague has worsened slightly (from -1.5% to -1.6%), due in part to a strong development pipeline that has resulted in overall supply significantly exceeding tenant demand. Budapest's recent improvement (from 1.0% a year ago to 2.8% in May) has reversed with a likely outturn for 2015 of around 0.2%, based on current forecasts received. Vienna is the only centre expected to deliver better than 1.0% growth, although the current projection has fallen over the last six months by 0.7% to 1.4%.

Across the wider eurozone markets, those expected to provide the best growth in 2015, in addition to Dublin, Barcelona and Madrid, are Helsinki (4.6%), Berlin (3.4%) and Munich (3.0%). The remaining seven locations are all expected to exceed 1.0% growth.

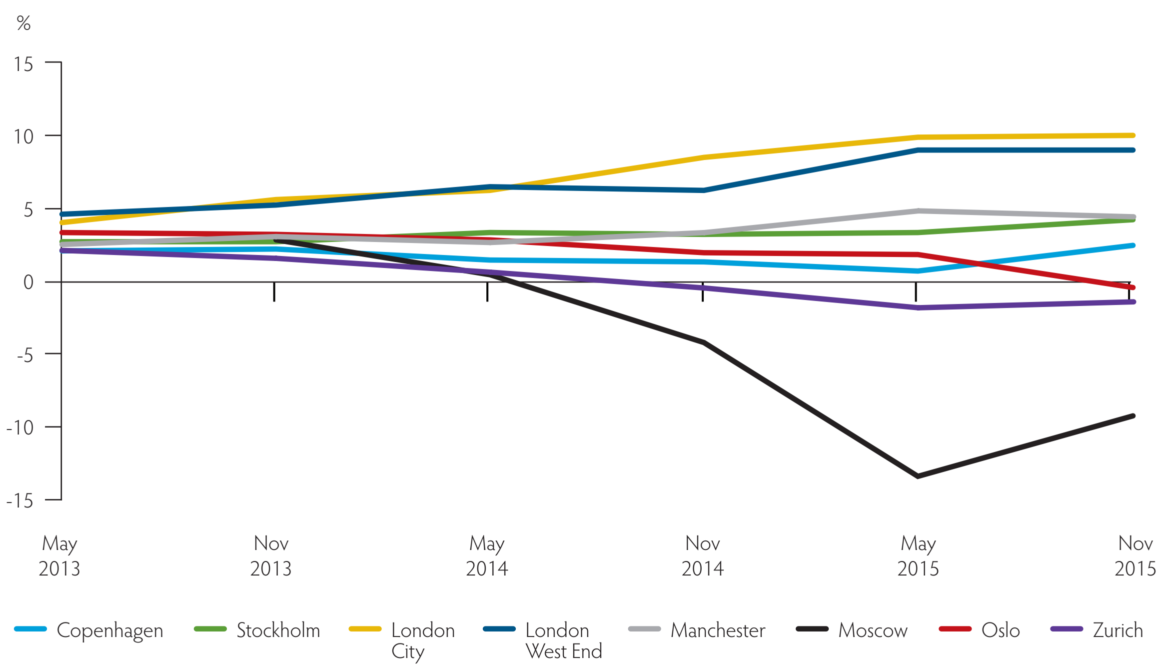
OUTSIDE THE EUROZONE

Prospects for growth in five of these eight locations are positive for 2015 and six forecast averages have improved over the period since the May survey (see Figure 2). The most significant change, however, has been the decline in sentiment for Oslo, the forecast for which has dropped to -0.4% as the Norwegian economy has been adversely affected by the fall in global oil prices and weaker business projections, resulting in a downward revision to GDP forecasts. The office market has been further impacted by high levels of construction activity with a number of schemes completing.

The two remaining markets where rents continue to contract are Moscow (at -9.3% for 2015) and Zurich (-1.2%). With the Russian economy contending with sanctions and shrinking growth, demand for office space has declined considerably. However, with overall construction activity falling and schemes being withdrawn until stronger fundamentals are seen in the occupational market, the downward trajectory of rents appears to have been reversed.

A surge in occupier demand, coupled with limited stock as few schemes are coming to completion, has caused central London vacancy rates to drop to a 15-year low in the third quarter (to around 4.7%), as

Figure 2: **Weighted average rental growth forecasts 2015 – Non-eurozone centres**

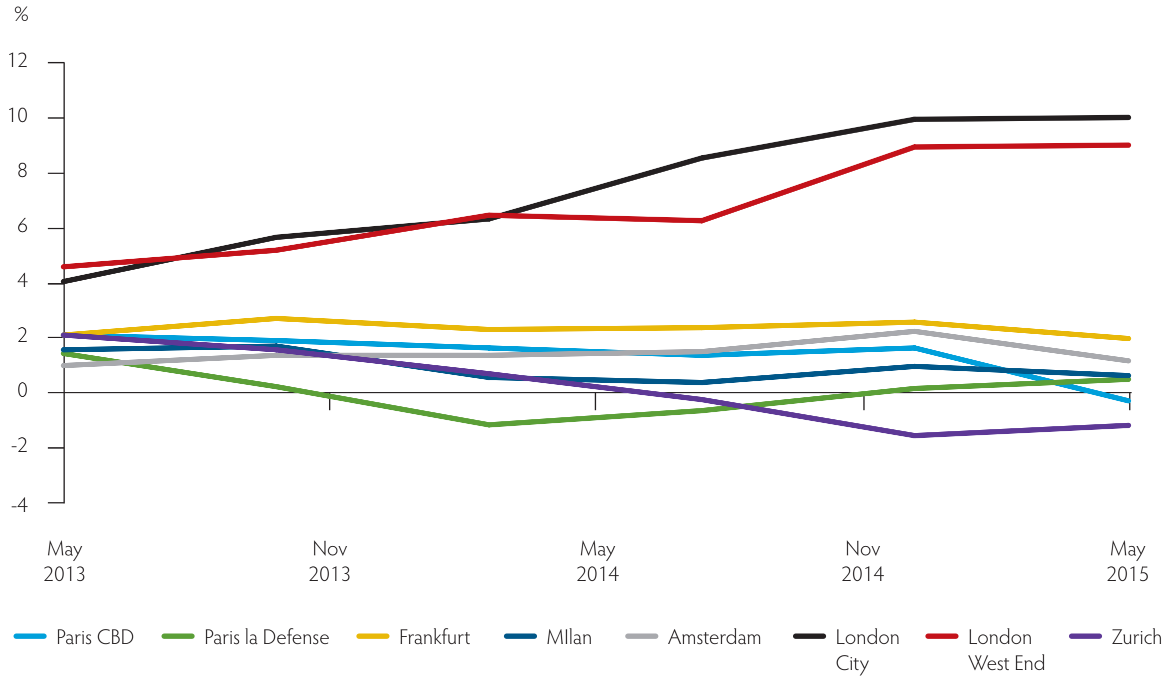


take up for the year reached almost 10.8m square feet in the last three months, representing 18% above the long-term trend.

FINANCIAL CENTRES

With the exception of London and Zurich, all the financial office markets surveyed have experienced a softening in forecaster sentiment over the last six months. An expectation of modest growth in 2015 is illustrated by Frankfurt, projected to achieve around 2.0%, with Amsterdam, Milan and Paris La Defense all weakly positive at between 1.1% and 0.5%, whilst the Paris CBD forecast has fallen to -0.3% (representing a 1.9% drop from May's average). Conversely, Zurich has improved slightly (to -1.2% from -1.6% six months ago).

Figure 3: **Weighted average rental growth forecasts 2015 – financial centres**



NORDICS

Three of the four locations are showing a strengthening in growth rates, with the central area of Stockholm starting to see a fall in vacancies for quality stock, which has underpinned improved rental growth, rising from 3.3% in May to 4.2% currently – see Figure 2.

Projections for the Helsinki office rents have continued to rise with average expectations now at 4.6%, from 2.4% six months ago. This appears to be in response to occupiers moving to superior locations or better specified accommodation. This trend is also prevalent in the Copenhagen market, where the decline in growth recorded over the last four surveys has been reversed with the 2015 forecast now averaging 2.5% from 0.7% in May.

The predicted 2015 growth rate for Oslo has continued to fall, from 1.8% in May to -0.4% currently. This weakening, as mentioned previously, has been driven by a combination of falling oil prices, resulting in lower economic growth forecasts, and an excess supply of stock in the Norwegian capital, as tenants have tended to postpone or reconsider relocating to new or larger premises.

2016 and beyond

The 2016 forecasts now suggest four of the 29 centres surveyed are projected to deliver negative growth, compared to only Warsaw six months ago. Forecasts have softened in 14 markets since May and in only three instances have predictions improved by more than 1.0%, these being for both of the Spanish markets and Dublin. In total, 13 markets are expected to grow by 2.0% or more over the next 12 months, led by Dublin at 10.6% and Madrid at 9.2%. Confirming May's expectation, the greatest improvement is likely to be seen in the Moscow market, where the average projection of -0.9% represents an 8.4% improvement on the 2015 average, although the range of individual forecasts lies at 11.4%.

The forecasts for 2017 average 2.2% across all centres, ranging from 7.2% for Madrid to 0.4% for Warsaw. Twenty of the market forecasts have improved over the last six months, with 16 locations equal to or better than the average. No geographic pattern appears to explain the spread of expected performance.

In absolute terms, the figures show declines in the growth rates of 13 centres between 2016 and 2017. As reported in May, the biggest potential fall may be experienced in the Dublin market from 10.6% to 2.8%, albeit both projections are an improvement on those previous reported (6.7% in 2016 to 1.5% in 2017). In seven of the remaining weakened predictions, forecasts are less than 1.0% lower than their respective 2016 figures.

3- and 5-year average forecasts show markets broadly in recovery

The three-year average forecasts point to Warsaw, Moscow, Oslo and Zurich, delivering sub-zero growth on an annualised basis, albeit the latter two are only marginally negative, at -0.4% and -0.1% per annum respectively.

With the exception of Warsaw (at -0.6% replacing Moscow, previously -2.0%), all five-year average forecasts indicate positive growth.

Forum Activities and Announcements

Scotland Seminar and Dinner

The second Scotland Seminar and Dinner was held on 2 September at the Caledonian in Edinburgh. The seminar focused on 'The Outlook for Scotland', with speakers **Savvas Savouri**, **Professor Alex Kemp** and **Andrew Creighton** providing overviews of the economic and political climate, prospects for oil & gas and property respectively.

l/r: Fraser McPhail (IPF Scotland Chair), Savvas Savouri, Andrew Creighton and Professor Alex Kemp.

'Mind the viability gap: Achieving more large-scale, build-to-rent housing'

The UK has consistently failed, over five decades, to deliver sufficient housing to meet the country's needs. The impact of this under delivery has compounded and now manifests itself in house prices, locally and nationally, that are unaffordable to much of the population. At least 240,000 new homes need to be delivered annually to start to bring down house price inflation to a similar level as general price inflation. However, since 2008, output averages fewer than 150,000 homes annually and the 240,000 target has not been achieved since 1980.

Against this backdrop, the IPF published the above-titled briefing paper is to help inform further discussion of the issues impacting the viable delivery of new build, large-scale, professionally-managed residential rental accommodation, now often described as 'build-to-rent'. The paper provides a comparative analysis of the build-to-rent and build-to-sell sectors, identifying the barriers to market, such as the build-to-rent sector's lower annual rate of return that falls short of investors' requirements. Solutions are suggested, including consideration of affordable housing allocations, planning conditions, covenants and vendor land receipt levels.

This was presented at a launch event on 22 September, with guests invited from the public sector.

To download a copy, please go to the IPF website: **www.ipf.org.uk**

Expo Real

The initial findings from new IPF research that looks at the impact of globalisation and improved transparency on the 'investibility' of emerging markets were presented at Expo Real in October. The final paper was presented in London on 2 December and the paper will be published shortly.

IPF event at Expo Real
l/r Pam Craddock, Andrew Burrell, Simon Wallace and Simon Mallinson

25th IPD/IPF Property Investment Conference


Goh Kok Huat, GIC

The 25th conference in Brighton included presentations on a wide range of topics from the the global politics of energy, a keynote address by Goh Kok Huat, Chief Operating Officer and President of Real Estate, GIC on investing globally and two presentations by futurologists looking forward to the next 25 years.

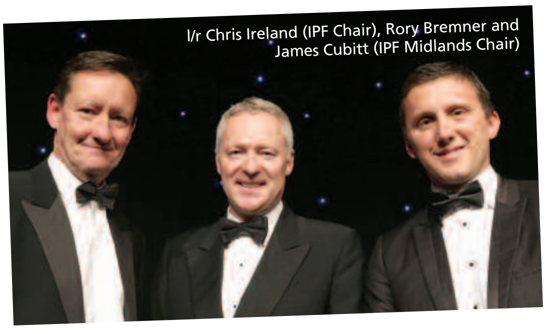
IPF Investment Agency Protocol

As reported by the IPF Chairman, Chris Ireland, at the IPD/IPF Conference, one year on the Protocol has led to an improvement in the functioning of the market but that there is still more work to do in terms of getting the key messages embedded in market practice. To help with this, five of the top investment agency firms have put together and funded an online training module.

The module, and supporting material, will be available on the IPF website in the New Year – WATCH OUT FOR ANNOUNCEMENTS!

Midlands Dinner

The Midlands Dinner took place on 15 October at the ICC in Birmingham. Once again, the event was a sell-out. **Rory Bremner** was very well received as the after-Dinner speaker.


l/r Chris Ireland (IPF Chair), Rory Bremner and James Cubitt (IPF Midlands Chair)

Nick Tyrrell Research Prize

After reading the 36 submissions from across the globe, the Judging Panel from joint sponsors INREV, IPF and the SPR awarded the fourth Nick Tyrrell Research Prize to Pat McAllister and Anupam Nanda of the Henley Business School for their paper **'Do Foreign Buyers Compress Office Real Estate Cap Rates?'**

A summary of the key findings from the research is on pages 2-6.

The Nick Tyrrell Research Prize is awarded annually to innovative and high-quality, applied research in real estate investment. The deadline for the 2016 Prize is 30 May 2016. Full details of the Prize and submission process can be found on page 48 of this publication and on the IPF website.

PDIG Paper 1: Property Future Contracts


IPF Investment Property Forum

PDIG PAPER NO.1
October 2015

PROPERTY FUTURE CONTRACTS: AN INTRODUCTION

The above paper was launched at the Q3 2015 IPD/IPF breakfast on 3 November. Written by the Property Derivatives Interest Group (PDIG), this paper explains the structure of property futures, investment advantages and provides an overview of the property futures market. Related costs, pricing, risk and property futures' role in portfolio rebalancing are also discussed.

To download a copy, please go to the IPF website: www.ipf.org.uk

Northern Dinner

The Lowry in Manchester was the venue for the sold-out Northern Dinner on 26 November. **John Lloyd** proved to be a very entertaining after-Dinner speaker.


John Lloyd

Site visits

There were a number of site visits for members in the last three months. These included a visit to the new Jaguar XE production line at the **Land Rover factory in Solihull**, the **Sky Garden at the top of 20 Fenchurch Street**, the **Victoria Estate** and **The Bower, Old Street**.

Many thanks to the respective organisations for allowing access to IPF members.


New Jaguar XE

IPF postgraduate dissertation prizes

As part of its 25th anniversary year celebrations, the IPF established the IPF Postgraduate Dissertation Prize for the best dissertation produced by students on the 10 IPF 'recognised' courses (a full list of these courses can be found on the IPF website).

The £500 Prize is intended to provide further support for educational courses about property investment and/or finance and to help foster closer links with academic institutions.

Most of the recognised courses submitted dissertations in 2014 and we hope for a 'full house' for 2015.

End-of-Fund-Life project

AREF, IPF and INREV have formed a Project Group to consider best practice relating to the end of life period for closed-ended real estate funds. This project was triggered by the increasing number of funds that have reached the end of their life, triggering the process of liquidation, restructuring or extension, with varying degrees of success.

Headline results from this work are due for release in the New Year, with publication of the full report expected in May 2016.

Save the Date

Midlands Annual Lunch

22 April 2016
The ICC, Birmingham

Annual Dinner

29 June 2016
The Grosvenor, London

Scottish Seminar & Dinner

Early September
Date & venue to be confirmed

Midlands Annual Dinner

6 October 2016
The ICC, Birmingham

IPD/IPF Property Investment Conference

17-18 November 2016
Brighton

Northern Annual Dinner

24 November 2016
The Lowry, Manchester

For further details of these events, contact Barbara Hobbs: bhobbs@ipf.org.uk

Membership subscriptions 2016-17

Notice to renew your membership for 2016-17 will be sent out by email week commencing 8th February.

We would be grateful if you could renew as soon as possible after receipt in order to reduce administration costs.

For any enquiries relating to membership, please contact Cormac Watters: cwatters@ipf.org.uk

About the Nick Tyrrell Research Prize

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

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

1. The Prize

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

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

2. Prize criteria

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

3. Submission of papers

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

4. Management of the Prize

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

5. Other issues

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

Judging Panel (2016)

Paul McNamara (Chair)
Marc Francke, University of Amsterdam
Martin Hoesli, University of Geneva
Nick Mansley, University of Cambridge
Andrew Smith, Mill Group

Secretaries (2016)

Dr Paul Kennedy email: paul@pjkennedy.co.uk
Henri Vuong email: henri.vuong@inrev.org

Recent IPF Research

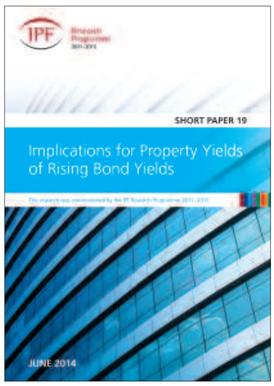
As one of the largest property research programmes in the UK, the IPF Research Programme supports the Forum's wider goals of enhancing the understanding and efficiency of property as an investment class.

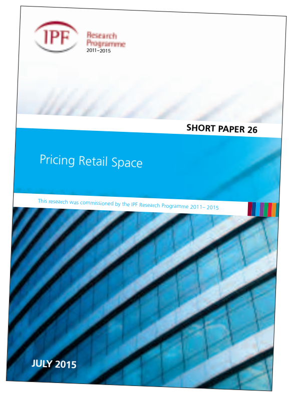
The IPF produces a number of regular surveys, including the UK and European Consensus forecasts, as well as the annual 'UK Residential Property Institutional Attitudes and Investment Survey' and report on 'The Size and Structure of the UK Property Market'.

Listed below are the most recently completed research projects. These, together with earlier reports, are available to download from the IPF website.

Short Papers Programme:

- UK Development Finance Review 2015
- Pricing Retail Space
- Implications of a UK Withdrawal from the EU: Discussion Paper
- What is Fair Value?
- What Constitutes Property for Investment Purposes? A Review of Alternative Assets
- A Review of Interest Rate Hedging Strategies
- Residential Investment in International Markets
- Zombies and Beyond: A Further Update on UK Real Estate Debt
- The Implications for Property Yields of Rising Bond Yields
- Constructing an Effective Rental Value Index
- Implications of the Eurozone Crisis for the UK Real Estate Market and UK Investors
- Institutional Attitudes to Investment in UK Residential Property
- Property Banking Forum: Outlook for Development Finance





Major Reports:

- Individual Property Risk
- Liquidity Pricing of Illiquid Assets
- Estimating Liquidity in Real Estate Markets - Literature Review
- Liquidity in Commercial Property Markets Summary
- Prospects for Institutional Investment in Social Housing
- Time to Transact: Measurement and Drivers
- Carbon Penalties & Incentives: A review of policy effectiveness for carbon reduction and energy efficiency in the commercial buildings sector
- The Size and Structure of the UK Property Market 2013: A Decade of Change
- Returning to the Core – Rediscovering a Role for Real Estate in Defined Contribution Pension Schemes
- Modelling Causes of Rental Depreciation for UK Office and Industrial Properties
- The Role of Commercial Property in the UK Economy
- Reassessing the Accuracy of UK Commercial Property Forecasts
- The Future of Property Forecasting
- Costing Energy Efficiency Improvements in Existing Commercial Buildings

IPF Investment Property Forum

Annual Lunch 2016

Friday, 29 January

London Hilton on Park Lane,
Park Lane, London W1

11:45 Pre-Lunch drinks
12:30 Lunch
14:30 Guest Speaker
15:00 Lunch finishes and bar opens

Lounge Suit

Guest Speaker:
Rt Hon Ken Clarke QC MP

Ticket price: £120 +VAT

£144 inclusive of VAT @ 20% per person.
The ticket price excludes wine and other beverages.

Please contact Barbara Hobbs on 020 7194 7924
to reserve tables for the Annual Lunch.

This event is kindly sponsored by:

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