

PROPERTY PANEL



THE PANEL

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 Hymans Robertson

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FUND MANAGEMENT LTD

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Panellists discuss the best property investment strategies to adopt after the US sub-prime crisis

Henderson: In light of the sub-prime crisis in the US, would it be prudent to say property investors should rightly be nervous of a more challenging environment for valuations?

Yeomans: Definitely. The squeeze on credit will adversely impact values. It is already more difficult for individuals to get loans and they come at a higher rate of interest. Institutions are nervous and unwilling to gamble, with potential valuation changes on the horizon. Investment transactions have already reduced significantly. It is difficult to assess the "right" price at which to market a property.

It will certainly be lower than last year's valuation and the market is continuing to fall away. The RICS has recently said commercial property would fall 5pc this year; others are predicting 10pc. In the end the limited number of potential buyers will determine the price. If the expectations of property owners and those of potential buyers continue to diverge, deal-making will remain difficult. Then the problem becomes self fulfilling. Without current evidence of investment transactions, valuers will be ultra cautious and likely to mark down values accordingly. One can understand them playing safe in their quarterly and end of year valuations.

Martin: One effect of the US sub-prime crisis on wider asset markets has been to encourage investors to make more careful assessments of risk. A cornerstone of our investment process has always been a structured appraisal of the risks attached to particular assets, and whether the potential returns available justify those risks. This applies both to purchases as well as the analysis of properties already held as they progress through their life cycle. Portfolios structured in this way are believed to be defensive in an environment of more modest capital growth.

Radford: The US sub-prime crisis has definitely had the knock-on effect of making lenders more cautious. This has already been reflected in more restrictive bank financing terms offered on some property transactions both in terms of interest rates and the amount of equity input required. With the property market experiencing a fall in values at the current time, banks are also rightly exercising more caution over the accuracy of property valuations.

Balfour: The full impact of the sub-prime crisis in the US will take many months to work through into the world economy. In the short term there has been an impact on investor demand for UK property and a reduction in trading volumes. We believe there will be a pricing correction in the market for property investments and evidence of this is starting to come through.

Aitchison: The ING view is that the risk-free rate for all asset classes has risen as a result of the recent financial market turbulence. As a result this is not a phenomenon limited to property and needs to be considered in the context of the overall investment environment and the associated impact on the other asset classes. Property investors are likely to demand higher initial and equivalent yields, due

primarily to a step adjustment in the risk environment, rather than a fundamental weakness in the prospects for property. Underlying property fundamentals remain good with the impact of any negative yield movement likely to be mitigated by continuing rental value growth.

Ellis: Property valuations in the UK commercial market were already slowing prior to the recent sub-prime induced credit crunch. Predominantly the downward yield shift, and hence the strong capital valuation uplifts, that have been seen in the commercial property market over the last few years have come to an end and in certain markets and sub-sectors there is evidence and pressure to move yields upward, making for a more challenging valuation environment. The global lack of liquidity has now made the situation for property valuers even more challenging. However the occupational market generally is relatively strong in a variety of markets, and the key to delivering outperformance will be maintaining a level of yield, looking for properties that have higher than average rental growth and delivering on active management initiatives.

King: The full impact of the US sub-prime crisis has yet to fully work its way through the financial system. Its direct and indirect effects are already being felt although this is not the only factor which has caused the change of sentiment and market volatility. There is no doubt that valuing at times of financial turbulence and uncertainty is challenging and investors are right to be on their guard and demand that valuers accurately reflect the changing market conditions.

Francis: Returns were already slowing prior to this problem. However it has exacerbated matters. Sentiment in the market has shifted and is setting challenges for valuers. They are reflecting the changes to a greater or lesser extent with some taking a lead from the change in sentiment whilst others wait for hard evidence. Valuations of secondary properties look likely to suffer more whilst more prime properties, particularly with good-quality tenants and long leases offer more protection in an uncertain environment.

Morrogh: At the height of this bull market, there was a positive arbitrage between borrowing costs and the All Property Initial Yield. Quite simply, the rent receivable from many investments was greater than the mortgage repayments, making investment in UK commercial property highly profitable.

Since the start of 2007, the Bank of England has increased the base rate three times to 5.75pc, which combined with compressed income yields, has led to a return of deficit financing to the UK commercial property market. Whilst there is no direct link, the global credit crunch driven by the US sub prime crisis may have served to further increase the cost of borrowing, made debt harder to attain, and reduce the potency of the influential leveraged investor. There is however, a growing belief that 5.75pc will represent the peak for UK interest rates for the current cycle, and many forecasters expect rates to drift lower.

Dennis-Jones: It would be prudent to say investors need to be aware that valuations are likely to continue to decline in the next few months. This had started to occur before the sub prime crisis, as evident in the Investment Property Databank monthly index. One of the main reasons for this was that bond and finance rates had risen above property yields and were continuing to rise. The sub prime crisis has probably added to this price trend by making investors nervous, reminding them about risk and the need to properly value it. Lending margins have risen and this is true of the required property risk premium. On the positive side, rental growth and tenant demand are positive and bond and finance rates have fallen back from their peak in July to levels last seen at the beginning of 2007.

Hobbs: Even before the sub-prime crisis, there were signs of a weakening of the UK property market. The listed market had fallen by close to 20pc by the end of June, and there were rising concerns over the prospects for the direct market. With the IPD monthly index turning negative in August, it is likely that UK values will decline over the course of 2007 and this is set to continue into 2008.

So the UK market is weakening, but this is a downturn that has been anticipated for some time and, more importantly, it is "cyclical". Real estate remains an attractive

asset class for a range of investors and the correction in its pricing could provide interesting opportunities for investors to increase their exposure.

Henderson: To what extent have bid prices on property funds widened on the back of strong demand from investors for redemptions, and if so, should investors now be prepared to accept lengthy delays in getting back their money?

Yeomans: Property is regarded as illiquid, even in a normal market but unit-linked funds will be forced to sell as their cash floats are exhausted by withdrawals. In the current market, this is bound to take longer and inevitably investors will face lengthy delays before getting their money out. Owners that have to sell must be realistic.

Martin: There is no doubt that the flow of funds into pooled property funds has slowed in recent months, including those serving pension fund clients, but substantial redemptions have been the exception rather than the rule. In terms of the potential to realise investments in a particular fund, that is clearly dependent upon the rules of the scheme. However, the slowdown in fund inflows had been anticipated and certainly our funds have been targeting somewhat higher liquidity levels for some time.

Radford: There is evidence there has been a significant increase in redemptions in UK PUT's over the last two quarters and in some cases bid prices have been reduced markedly. Despite this, investors should not accept lengthy delays in recouping their money as the redemption policies and timescales should be clearly summarised in the fund's trust deed.

Balfour: We do not anticipate a long-term movement of money out of property funds. The current uncertainties arising from the credit crunch are affecting all capital markets including property. The occupational property market is still healthy without signs of over development or supply overhangs. After a pricing correction we anticipate that property returns will recover and the sector will remain attractive to investors.

Aitchison: Our own unauthorised unit trusts have not experienced investor redemptions beyond the norm and in the authorised sector, i.e. retail investors, net fund flows remain positive albeit well down on last years levels. In terms of liquidity, there is a trade off. Those investors requiring instant access should seek listed funds albeit they will also need to accept the potential for increased volatility. However, the majority of institutional investors are long term and instant liquidity is not, in our experience, a key priority.

Ellis: The traditional bid and offer spread for institutional investors on the primary market (i.e. creating new units in a fund) have not changed at all, as prices should reflect the cost of buying and selling the underlying direct properties. However, as there are generally more sellers of property funds at the moment than buyers (in contrast to the situation this time last year), most secondary

market prices on funds have tended to drift towards bid prices or below in order to match expectations of both the selling and buying parties. Delays in returning any money will be subject to a variety of factors including the level of cash or other liquid assets within a fund.

King: It has been widely publicised that as a result of investors' redemptions a number of funds have reduced their bid prices. The length of time investors may have to wait before receiving their money following requests for redemptions will depend on the liquidity levels of the fund in question and whether there are other investors looking to buy into that particular fund. If there are more sellers than buyers and liquidity is low, then a fund may have to sell assets. Sales can take time to complete and investors understand that forcing any fund into a "fire-sale" position would be detrimental to both exiting and remaining investors.

Francis: It will depend on the terms of individual funds but, in simple terms, for open ended funds where there are more redemptions than creations, you can expect these redemptions to be made at, or close to, "bid" prices. This should reflect the actual cost to the funds of selling properties out of the funds in order to meet the redemption. It should be a means to protect the remaining investors in the fund and not a penalty. This has been misunderstood by sections of the media. Timing should be governed by terms of the fund and hopefully investors were aware of these at the time of investment.

Morrogh: This question makes reference to how a number of the high-profile retail funds are dealing with potential redemptions. TPFM does not wish to speculate on how such funds propose to manage their liquidity.

Dennis-Jones: For institutional funds, bid/offer price spreads will not have widened on the back of demand for redemptions because they are calculated for each fund in accordance with a formula. Typically it reflects the total costs of buying and selling the fund's portfolio of property assets. This has not changed. As to whether investors should prepare themselves for delays in getting their money back will depend upon which exit route they take. If units are priced attractively in the secondary market, probably some way below bid price at the current time, then there should be few delays. If the seller wishes to achieve bid price by redeeming their units from the manager, then there are likely to be delays while the manager sells properties to fund the redemption, unless there is cash available.

Henderson: Is there any sign that the "European" property story has reached some conclusion, or are most UK property investors still stuck on the introduction?

Yeomans: Investors are still interested in this market as yields are higher and the cost of borrowing lower. This interest rate margin is being squeezed but the recent turmoil in credit markets has made further rate rises by the European Central Bank less likely. Therefore, we are

probably mid stream in the market, with arguably some compression in yields still to go, although not much. Inflation may push rents up in some European cities, and the more buoyant economies are generating additional tenant demand. The smart move would be to take advantage of the opportunities that we expect to appear in the UK market following the round of year end valuations.

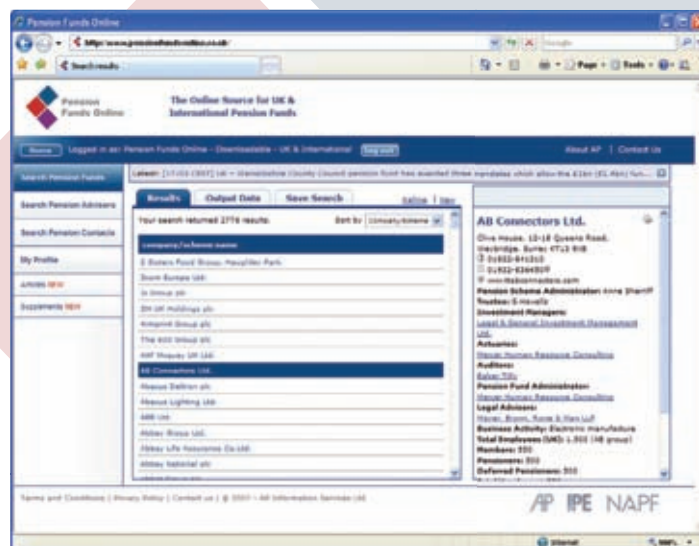
Martin: Investors in either UK or continental European property, or indeed both, have had the benefit of robust returns over the past several years. While the continental cycle is still some way behind that in the UK, there is nonetheless evidence that it is maturing. This has prompted UK investors to review their options for investing in markets further afield, particularly with regard to Asia-Pacific and to a lesser extent in the US. This suggests a trend towards investors reviewing property allocations at a global level.

Radford: The source of returns from European property investment has, to varying degrees been the same as in the UK over the last two-three years, i.e. yield compression. There is certainly evidence that this is now coming to an end, although there is still some scope for further inward movement of yield in some countries and sub sectors. Equally some sectors are beginning to look overpriced. To this extent late entrants are less likely to obtain above average returns.

Balfour: European property will remain an attractive sector for UK investors for reasons of diversification and the differences in economic cycles. Not all funds are fully invested in the sector. We expect a slowdown in performance as the impact of yield compression declines.

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Aitchison: The European property market lags the UK by around 18-24 months. As a result, European property is likely to see stronger rental value growth than the UK over the short to medium term. The European markets are also likely to experience some fallout from the recent financial market turbulence.

Ellis: Some European property markets have had such a significant downward yield shift recently that they are now at initial yield levels comparable to other more established western markets. Hence, we believe that some of these markets are definitely reaching the last few chapters through occupational demand remains reasonable.

With the differing economies and prospects in each sector, there is still potential to invest in many markets across Europe and for UK investors to gain significant advantages.

King: In our experience while many UK investors have explored the idea of diversifying into Europe, the majority have not actually followed this in practice. Natural home country bias, lack of local expertise and transparency, as well as shortage of suitable tax-efficient investment vehicles, are some of the reasons.

However, with the period of double-digit returns offered by UK property behind us there will undoubtedly be fresh impetus for more UK investors to take the plunge and increase cross border investment into Europe. At Credit Suisse for example, we are developing new European real estate products that are specifically tailored for UK investors.

Francis: Many UK investors have been investing not only in Europe, but in PRUPIM's case – Asia and North America as well, for a number of years. More recently we have seen the growth in both balanced and specialist investment vehicles making it easier for pension funds and other investors to take European property exposures. The indications are that investors are increasingly favouring continental Europe over UK as returns here are slow.

Morrogh: The bullish story for European commercial property remains intact, namely the relatively stable returns, the high-income diversification by way of correlation to other asset classes and the potential to enhance returns through good asset management. By focusing solely on UK property, investors are excluding the other two thirds of the European real estate market. We believe that rates will remain on hold at 4pc over the remainder of 2007 and into 2008.

Dennis-Jones: If by the "European" property story, this refers to UK property investors having completed their switch from UK funds to European ones, then it seems that while target European funds have been identified and are available for investment, investors are finding it challenging to sell or redeem units in UK funds for the reasons previously identified. In the short-term, of course, some of the negative factors affecting UK property may start to impinge on continental European property.

Hobbs: Property markets in continental Europe have become increasingly attractive for UK investors for a range of reasons. Most fundamentally, they tend to be far less mature

than the UK market but are undergoing significant structural change.

The need for better quality retail, office and industrial property, and the huge pressure for sale and leaseback generate scope for stronger performance, particularly for more value-added strategies. Beyond these structural changes, many European markets are at a more attractive stage of their cycle than the UK, with less aggressive pricing, less supply and better prospects for rent growth.

Over the past 18 months there has been a surge of interest from UK investors in the European market, and this is starting to be reflected in capital flows. After

representing less than 5pc of investment purchases in continental Europe during the early years of this decade, there has been a sharp rise in activity, with UK investors accounting for around 15pc of purchases during the first half of 2007.

Most of these investments are part of a long-term strategy to increase exposure to the European market.

Henderson: Help or hindrance? How has recent market volatility impacted property?

Yeomans: Indirect UK investments, real estate investment trusts and property company shares, have performed poorly. Just before writing this I saw British Land's share price had fallen by a third this year and it has had to

pull the planned sale of 75pc of Meadowhall shopping centre. I have run a unit-linked fund and am sure it will hinder them too.

Unless or until sellers lower their expectations, deals will be very difficult to conclude.

Already we are seeing difficulties at the lower end of market, presumably because individual investors are finding it tougher to get credit while others are waiting for value realignment. HSBC expects sterling to fall sharply and trigger an exodus of hot money from abroad. This will take any remaining froth out of the property market. But we do not expect a crash.

Martin: The last few months have been relatively turbulent for most asset markets, including that for UK commercial property. The move from offer to bid pricing for some retail funds in the early summer has been followed more recently by the "credit crunch".

Currently, a number of property investors are adopting a wait-and-see approach which has led to a reduction in number of investment transactions. However, most commentators expect a return to more stable conditions over the next few months, which will help to restore activity levels in the investment market.

Radford: The recent volatility in the global finance markets has definitely made institutional investors more cautious and in the UK market it has resulted in Institutions following a "wait and see" policy to further property investment. The turmoil has resulted in a sharp reduction in the number of property transactions being completed which is affecting both property values and also impacting negatively on the perception of commercial property market generally.

Balfour: The recent volatility in listed markets has caused investors to reconsider their strategy and reduced activity in the direct property investment market. After a pricing adjustment we anticipate that investors will return to the direct property market based on returns driven by property market fundamentals.

Aitchison: Consistent with the other asset classes, the property market is probably at the point of maximum uncertainty. The end results are still unclear but some key features have occurred: Investors appear to have increased risk aversion; the risk free rate has increased (as evidenced by gilts); and there has been a flight to safety in some markets.

We also believe that the volatility of the stock market shows property in a positive light. Its characteristics, i.e. having a strong risk-adjusted return, offering a bond as well as equity-like component and its asset liability matching potential, mean that property is ideally placed to meet the requirements of the long-term investor, irrespective of any short-term volatility.

Ellis: The volatility that has been seen in the last few months relating to rising bond yields and interest rates, the sub-prime crisis in the US, and the general worldwide credit crunch that has followed, has not particularly helped any asset class other than cash!

With a lack of liquidity in the market, this has affected the position of many buyers and the ability to raise debt. Generally there is a very slow investment market for property, as investors are looking to see at what levels the market plateaus. There will however always be specific stock-led examples, where transactions are able to be completed based on local characteristics.

King: We have long held the view that the UK property market was heading for a correction. Recent market volatility, US sub-prime crisis and shortage of liquidity have led to a worsening of the already negative investor sentiment towards UK real estate and resulted in a sharper correction than most forecasters anticipated.

We expect this negative trend to continue in the near term with further re-pricing across all sectors and we have now seen a shift from a seller's market to a buyer's market. This, of course, will provide good buying opportunities for those funds and investors who are cash rich.

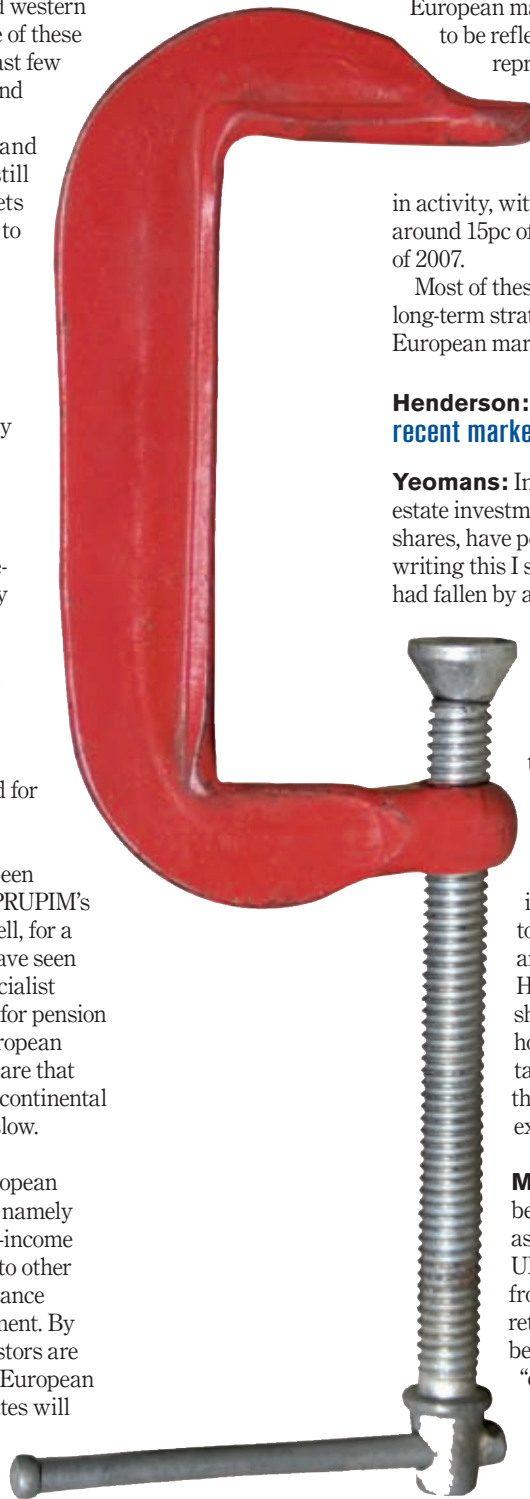
Francis: It is worth remembering that the demand from occupiers for commercial property generally remains solid and rents continue to grow. There is some evidence of expansion plans being postponed but no major impact yet.

However it has had a major impact on investors that rely on debt to fund their purchases. It will also have an effect on investors that need to re-finance existing debt. The open ended funds are also seeing reduced inflows or, in some cases, outflows. This is reducing the number of buyers that, in turn, creates opportunities for cash buyers and brings some greater rigour to the market.

Morrogh: Following 14 consecutive years of positive property returns and an annualised IPD total return of 13.3pc over the last 10 years, the property investment market is cooling.

However, unlike the commercial property downturn of the early 1990s, the UK economy appears broadly healthy, interest rates are still relatively low (5.75pc against 13.9pc in 1990) and rental values in the main appear sustainable, with a number of forecasters predicting average rental growth of around 3.25pc per annum for the period 2007 – 2009 (principally driven by central London).

UK commercial property offers low volatile,



income dominated total returns, with a weak equities/bonds correlation and continues to play an important role in well-diversified investment portfolios. The benefits of property investment as an asset class have been particularly emphasised through 2007, as both bond and equity markets have fluctuated wildly.

Dennis-Jones: For most investors, volatility in any market is a hindrance as it adds to the uncertainty which caused the volatility in the first place. Thus the recent market volatility has not been helpful.

However for some investors, it has been difficult to find the right property at the right price. These would say it is helpful to restore prices to a more justifiable level and is aiding the efficient working of the market.

Hobbs: Clearly, the downward pressure on UK property valuations represents a challenge for the market, particularly when other asset classes, such as equities, have started to deliver stronger performance.

But, there are a number of silver linings in the recent market volatility. First, the increased caution from lenders means the availability of finance has reduced and its cost has increased. This "squeezing out" of the highly geared investors means there is less competition for the traditionally core and value-added investors.

Second, the volatility means it will be harder to gain finance for development, thus reducing the potential for excess supply at the end of the decade. This could be a classic case of "short term volatility providing longer term stability" by holding up rent growth for longer during the cycle.

Third, many UK investors will see the weakness of the domestic market as a catalyst for increasing their exposure to other property markets such as those in Europe and further afield.

Henderson: Has socially responsible investment had any meaningful positive or negative impact on property performance?

Yeomans: Policy decisions of this kind are traditionally a matter for our client funds but European directives and evolving building regulations will force the issue. We will all be obliged to adopt the "green" agenda, whatever we think of global warming.

Already, anchor tenants like M&S are insisting on the highest targets for new buildings and developers will want to satisfy their customers. Within the Wilky Group of companies, which includes development activities, we are taking a keen interest in sustainable development and construction techniques, including zero carbon buildings, addressing things like wasteful construction techniques, new materials, recycling, use of grey water and power conservation.

There are cost implications and it remains to be seen if this can be reflected fully in higher rents and therefore investment value. Many financial bodies are unwilling to pay higher capital costs up front, despite demonstrable whole life savings. Currently, also, accounting procedures are too inflexible to show a best value outcome.

Martin: This issue has a number of dimensions: many people would include environmental, regeneration and ethical concerns under the umbrella of socially responsible investment.

The English Cities Fund, which is a joint undertaking between English Partnerships, Amec and Legal & General Property, has successfully undertaken a number of development projects in regeneration areas.

Furthermore, environmental concerns are increasingly at the heart of our business, both in terms of minimising the impact of the construction process as well as the ongoing carbon footprint of the buildings we develop and manage.

Radford: In the commercial sector it has had no demonstrably positive impact. Indeed it generally costs more to be "green" and given that there is no evidence of tenants being prepared to pay a higher rent to reflect these costs, the return to the investor/developer can reduce. There is no tax or meaningful incentive by government to encourage more social responsibility, which must change for politicians' targets to be achieved.

Balfour: There is increasing awareness of social responsibility and this is having greatest impact in the design and leasing of new buildings. There is also an increasing impact in existing buildings where landlords have more control, such as the management of shopping centres. We expect to see greater influence over time.

Aitchison: We have not yet seen any direct impact on performance from socially responsible investment. However, we do expect sustainable investments to play an increasingly important part of our portfolios. Sustainability is high on the corporate and consumer agenda and as such we have to be able to offer our tenants sustainable buildings and our investors sustainable investments.

It is almost inevitable that the market will eventually reach the point where "green" buildings will either command a higher rent (and therefore higher value) or "non-green" buildings will command a lower rent.

Ellis: We believe that socially responsible investment is an important aspect of any property investment strategy or individual stock selection decision. In the property market this has grown from pure environmental policies and strategies over the last few years, towards full sustainability programmes with realistic targets and relevant audits.

To date, this has probably not had a meaningful impact on direct property performance and there is little empirical evidence to rely on, but we do expect it to become more important going forward. The effect would be substantially positive in terms of the ability to attract tenants to buildings and making new and refurbished investments more attractive to investors, which is being illustrated at present in most investors' attempts to be seen as "greener".

King: The business case for favouring investment in a socially responsible way is becoming increasingly apparent. However, there is little definitive research which measures the impact of socially responsible investment on property performance. There is no doubt that the investment universe for socially responsible investment is growing.

More and more companies are seeking to act in a socially responsible way and this will undoubtedly increase demand for environmentally friendly buildings. The case of whether tenants are willing to pay higher rents for socially responsible buildings is yet to be proven, but we believe that over time the benefits of socially responsible investment will translate into better performing assets.

Francis: With so much going on in the market, it has been hard to discern the impact. However, as returns settle down, the effect will be more apparent. Furthermore the introduction of

energy ratings for buildings will bring the issue more into the open.

Evidence from Australia is that such issues are influencing occupiers' decisions and rental offers. Essentially it is an element of a building's cost of occupation and part of the depreciation calculation and part of the risk/return calculation to be considered when making or holding an investment.

Morrogh: Recent changes in legislation (DDA Act, Part L Building Regulations, Environmental Act etc) have forced all sectors of the property market into having an enhanced social conscience.

Compliance with such legislation is a costly exercise that materially affects appraisals on all forms of asset management ranging from refurbishment to speculative development. Landlords will increasingly look to absorb increased costs in rental values and as the property investment market cools, yields on noncompliant assets are likely to drift out.

Dennis-Jones: The answer to this question depends upon how one defines and interprets SRI. There seem to be very few property funds at the current time which follow and implement a full and literal SRI policy. This is probably because it is felt that this would exclude them from a number of investment opportunities (e.g. properties let to tobacco companies and off-licences) and impose additional costs relative to competing funds (e.g. building costs), thus potentially causing them to underperform.

Consequently, most funds have a policy of implementing SRI to the extent that it does not detrimentally impact fund performance. However, there are many SRI areas which are prudent to implement from a risk reduction and performance enhancement perspective. Undertaking environmental surveys before purchasing a property is one example.

Thus most landlords have been implementing these types of SRI policies for some time because it makes economic sense and should provide positive performance benefits. In the future, the impact on performance will depend upon how the costs or benefits of SRI change (e.g. from technology and legislation), and if it is a cost, the extent to which the tenant and/or landlord is willing and able to absorb the costs when they do not have an obvious economic benefit.

