

PROPERTY PANEL



THE PANEL

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Ready for the upturn?

The panellists discuss the prospects for the UK commercial property market

JOHNSTON: The Investment Property Databank (IPD) has suggested we should be cautious in using derivatives prices as a real-time guide to property values. Do you think that, interpreted with the right degree of caution, they provide any useful information?

GRIGSON: To give clients a balanced view of both sentiment and activity in the UK market over the past 18 months, we have been making use of a number of different sources of pricing information (valuation, forecasts, sentiment surveys, market reports et al). This means that clients have been able to see first hand the significant variation in pricing and opinion that has permeated the commercial property marketplace.

All measures are useful, but inevitably all of them have some limitations. While the market for commercial property derivatives is likely to overstate the peak to trough figure at some point, their price movement generates information that a prudent investor should not ignore, although as a relatively new market, the clients are wise to show caution in their use of that information.

YEOMANS: IPD is right to advise caution. Derivatives are not based on real market transactions, so they give no indication of current property values. Rather, they are one of several useful indicators of market sentiment about future performance prospects of the asset class.

The IPD's implied total returns from current derivative pricing are -20% for 2009, -0.5% for 2010 with recovery in 2011 at +10%. We believe this is moderately pessimistic because the IPD Monthly Index is now starting to show signs of modest improvement. But the other indicators also remain heavily weighted against property. The share prices of property companies remain extremely depressed and well-known real estate investment trusts (REITs) have had to discount their recent rights issues heavily.

ELLIS: We would echo IPD's cautious approach to reading too much into derivatives pricing. While the derivatives market is a useful development for many real estate investors, it is important to note that it is a relatively new market whose investor base does not necessarily replicate that of the direct property market and that liquidity can drop off further out on the curve. For these reasons, among others, we think caution should be applied when reading across from the derivatives market to the direct market and, though the derivatives market has recently appeared a better forecaster than most others of the extent of decline in the direct market, it is untested over a full cycle as an unbiased estimate of direct market prospects.

MARTIN: Despite the growth in notional value traded in recent years, the commercial property derivatives market still has some way to go before pricing can be interpreted as a pure expression of market expectations of returns; variations in supply and demand and concerns over liquidity still play a very significant role. That said, pricing does

provide a barometer of market sentiment and, alongside a number of other indicators such as REIT pricing, investor surveys etc., does provide some useful insight into the evolution of market sentiment and potential turning points.

JOHNSTON: It is usually right to be sceptical about walls of money from abroad, but do you see any evidence of increased interest in UK property from foreign investors as a result of sterling's depreciation?

GRIGSON: One of the reasons investors from overseas are attracted to the UK as an investment destination is its long term macroeconomic and political stability. While the global downturn has dented this perception to a small extent, we do not believe that the impact will prevent the return of overseas investors to the UK.

Recent contact with both existing and potential investors from overseas suggests that interest in the UK has been generated primarily because of the rapid price adjustment that has taken place over the past 18 months, with the currency shift being a bonus, rather than the catalyst.

YEOMANS: UK property is traditionally popular with overseas investors who like our longer leases. Lower values and generous yields mean UK property is attractive enough already but today's currency exchange rates are making it well-nigh irresistible. A property that cost £100m in 2007 might be valued at £75m today. Adding sterling's decline to the equation means that a buyer paying with dollars or euros would spend the equivalent of only around £50m.

Research by CB Richard Ellis for *Property Week* magazine last month revealed that, despite the international economic crisis, there is still €180bn (£165bn) available to spend on real estate. The report identifies three principal sources. Sovereign wealth funds are now recovering from the sharp fall in oil prices. German open-ended funds, which suffered massive withdrawals when their government guaranteed bank deposits, are now enjoying net inflows of capital. Most significant, however are the institutional investors who are sitting on large war chests, which they will open when they judge the time is right. We believe that time is getting ever closer.

ELLIS: While at the margin the decline in sterling should add to the UK's attractiveness, it is difficult to isolate its impact against a background of generally declining investment activity by overseas investors – though several recent buyers have cited the decline in sterling as an added reason to look at the UK. Other factors – much improved value and the UK's attractive leases primarily – will probably be more important in driving the stabilisation of the commercial market than weaker sterling, as the income streams from UK property will also have declined in foreign currency terms. Where the decline in sterling may have greater impact is for buying strategies less focused on income generation; the high-end London residential market, for example, is a prime candidate.

MARTIN: While the weakness of sterling has added an extra dimension, the figures suggest that overseas investors have largely kept faith with the UK market since it turned down in late 2007; though volumes were down, they were still net buyers in 2008. While it is certainly true that there has been evidence of heightened interest from overseas recently, sterling is only part of the story. Overseas buyers continue to be attracted by the fundamentals offered by the UK – a large, liquid and sophisticated real estate market with relatively landlord friendly lease structures. Added to that is the fact that the UK undoubtedly led most markets into the downturn and arguably is closer to a turning point than those that have so far felt less pain. The view among many veteran overseas investors is that the UK looks cheap!

JOHNSTON: Over 18 months into the downturn, we are still seeing new restrictions being placed on redemptions from some funds. Is a sluggish transaction market still to blame or have some managers been too slow in adapting to changed conditions?

GRIGSON: A review of the past 18 months supports the case that some managers have to an extent failed to adapt to the reality of current market conditions. Managers of open ended funds must serve equally the interests of both those investors who are redeeming positions in a fund and the majority who remain invested. Inadequate management of the independent valuation process and manager adjustment of the pricing mechanism can have unintended consequences for manager and investor alike.

Transactions have been very difficult to secure, but with a realistic approach to pricing, they have been possible.

YEOMANS: When we entered the downturn 18 months ago, some funds were undoubtedly surprised by the clamour for immediate redemptions. The restrictions they introduced around December 2007 were understandable because they were trying to protect other investors, who wanted to remain in the fund, from the consequences of forced sales. Like many of us these fund managers thought or hoped the downturn would be short-lived but, in fact, the market has continued to decline at an unprecedented rate. Hence the recent second wave of redemption restrictions. However, forced sales are eventually inevitable.

It's not so much the sluggishness of the market that is to blame as the natural reluctance to crystallise such a punishing loss of value.

ELLIS: Recent suspensions and deferrals have generally applied to retail investors rather than institutional funds, where risk-aversion continues to dominate sentiment, and where restrictions applied to one fund have tended to have a domino effect. In addition, some mixed asset class funds are reducing exposure to property as part of rebalancing necessitated by even worse returns from equities.

Undoubtedly the process of completing sales is taking considerably longer than it would have done two or three years ago and many transactions are being delayed or failing to complete. The transaction market remains particularly sluggish for secondary property and debt-funded purchasers, though for cash buyers in the prime market, especially for properties with long leases to strong covenants, we are seeing some evidence of increasing activity. Despite this, in the short term the difficult transaction market is likely to continue to be a problem for those looking to raise liquidity.

MARTIN: After the initial shock to the market towards the end of 2007, investor demand has been persistently weak and patchy, creating major challenges to agreeing and completing sales. But having the discipline to identify requirements for liquidity, set realistic pricing expectations and tenaciously following through transactions has enabled certain managers to dispose of stock and realise funds. By following this strategy, Legal & General Property has been able to maintain liquidity across all open-ended funds that we manage. But given the correction that has taken place so far and the discounts available for those with equity to purchase in what is still a difficult investment market, pension fund investors currently have the opportunity to secure high-quality assets at very favourable spreads to risk-free rates that are likely to see strong performance into the medium-term.

JOHNSTON: A recent Institutional Investors Group on Climate Change (IIGCC) report suggested trustees ought to be more aware of the potential impact of climate change on their property portfolios. Is this a consideration that is already affecting asset management and should trustees expect to see the issue addressed in the reports they receive any time soon?

GRIGSON: Commercial property is a commodity like any other. To succeed it must both adhere to the wider statutory framework and must appeal to its target market, a market which is now heavily influenced by the concerns about climate change.

Many issues highlighted by the recent IIGCC report are already considered as part of the due diligence process. For example, flood risk (both from inland and coastal sources) is a standard area that must be researched prior to any purchase.

In relation to the environmental impact of buildings themselves, the increased pressure from government in the form of ever tightening building regulations, combined with the now tangible desire for "greener" buildings from business, has continued to influence the practice of commercial property funds during both the acquisition and more pertinently, the ongoing asset management of a property.

Trustees need to be assured that this matter is treated seriously. However, we believe that they are more interested in seeing deliverable and considered action across a portfolio, rather than naively ambitious programmes to deliver unsustainable and potentially meaningless "green" targets.

YEOMANS: Trustees should appreciate that demand for sustainable buildings will continue to grow. The recession may divert attention from the green agenda – but only temporarily. All tenants want to reduce their utility bills and

other occupancy costs while major companies are pursuing corporate social responsibility policies that demand high environmental standards from the buildings they occupy and – increasingly – insist their suppliers adopt similar standards.

Tenant requirements and regulatory requirements will focus attention on ways to measure the excellence or otherwise of buildings, such as the BRE Environmental Assessment Method and Energy Performance Certificates, in the same way that fuel prices and New Car Assessment Programmes (NCAP) ratings have given us better cars. We have a huge legacy of older property that can never meet these standards and which will have to appeal to less discerning occupiers by making themselves appealing in other ways, such as cheaper rents.

ELLIS: As major supporters of, and contributors to, the IIGCC Report, we are closely involved in promoting awareness of climate change and sustainability issues. We fundamentally believe that incorporating climate change factors into the investment process across all asset classes, including property, is consistent with trustees' fiduciary obligations as well as appropriate to their wider stewardship responsibilities.

As well as having an in-house committee which promotes and supports sustainability issues we publish a quarterly summary of environmental and sustainability issues highlighting key developments in the area of climate change, as well as other environmental issues, and setting out our own response to them; this is included in our quarterly reports to all our segregated multi-manager clients.

We also undertake an annual survey of all indirect property funds in the multi-manager investment universe which helps identify which managers are addressing these issues.

MARTIN: Climate change and the wider sustainability agenda is becoming a major consideration for property asset managers. It's something we report regularly to our segregated and pooled pension fund clients on. Our responsibilities are two-fold: fiduciary and ethical. From a fiduciary perspective, it's essential that a portfolio is both attractive to occupiers and compliant with environmental legislation in the long term. We believe these characteristics enhance investor returns, and both place a requirement on an asset manager to make assets as sustainable as is cost-effective to do so. An asset manager should ensure the processes, mindset, and partnerships are in place to fully consider sustainability when purchasing, refurbishing, and selling assets. Secondly, it is important to note that the built environment produces 40% of the country's CO₂ emissions, so pension funds have an ethical responsibility to work to lower that effect.

