

REASON FOR OPTIMISM



Panellists discuss forecasts for returns in 2007, investing overseas, whether RPI plus 5pc targets are achievable, integration into LDI strategies and two wishes for the future

What are your forecasts for property returns for 2007 and beyond?

BUNNEY: While the outlook for 2007 continues to be strong, investors will inevitably need to adjust to lower return expectations. We forecast property to deliver very respectable returns over the next three years. Our forecast for 2007 is an 11pc total return forecast and an average of 8.9pc over the next three years.

DENNIS-JONES: In 2007 we are expecting, with the weight of money we can see in the market, that returns will be higher than the current consensus forecast of 8pc pa – perhaps 10-12pc. Beyond this we would expect real returns of 5-6pc per annum over the next five-to-10 years.

FRANCIS: The latest Investment Property Forum consensus forecast was 7.6pc for 2007, dropping to 4.8pc for 2008. This captures the growing mood that the days of high returns through continuing yield compression are over. Our own views, based on emerging evidence about sector market dynamics, place us modestly below the IPF figures to 2010. However, we have been pleasantly surprised before and could well be again.

HUGHES: We are optimistic about UK property returns this year and expect the current IPF consensus forecast survey to be too conservative – again. Thereafter, while positive about property, we think it unlikely investment demand will be as strong as it has been recently, with obvious consequences for yields and returns.

JORDISON: We envisage a continued appetite for commercial property in 2007 and beyond. We are forecasting IPD total returns to come close to double digits again during 2007, in the region of 9-10pc. We then anticipate two years of single-digit growth, comprising income plus a “more normal” level of capital growth.

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History has shown that over the long term, total returns from commercial property are dominated by income. However, the past three years have seen a departure from this conventional shape of returns, with the sector generating strong, yield-driven capital growth. This is a result of a vast number of eager buyers bidding up prices among a scarce number of reluctant sellers. We believe the sector is now due to revert to its more conventional performance drivers, namely rental income, rental value growth and the ability to maximise returns from assets held.

MACLEOD: Within the UK property market, we would expect a return of 8pc for the calendar year 2007, with the next five years returning 7.2pc per annum. There is still a significant weight of money looking to invest in property from a wide range of investors, including UK institutions, high-net-worth individuals and foreign investors, which will help sustain the current yield profile (if not marginally improve it). Although the overall rental recovery has been slower than expected, there are now clear signs of improvement in specific markets other than central London offices.

The pan-European market is expected to perform better than the UK with double-digit returns (11pc+), much of which will be due to greater yield compression, predominantly created by the investor demand itself.

Further afield, property returns will be more exciting in India, Asia and South America where ungeared returns of 15-20pc are expected, although the exposure to risk is far greater and liquidity remains a key factor.

MARTIN: All property returns are projected to remain relatively robust in 2007 on the back of continued positive sentiment from a range of investors. But we believe sentiment will moderate over time and are forecasting returns of around 6pc per annum over the next five years.

Within the segments, five-year returns are led by the offices sector, with a particularly strong performance from the City of London market in the short term. Within retail, we see the strongest performance coming from the retail warehouse sector. Although industrial availability is forecast to remain relatively high over the next five years, we still see good prospects for well-located and well-specified stock.

NEWSON: Our forecasts for 2007 suggest a slow down from recent years to a figure of 7.5-8.5pc. This return is predicted on the basis that 2007 will be a year of primarily income yield generated performance with marginal (compared to the last three years) yield movement. The yield changes will be both positive and negative determined in the main by the rental growth forecasts, and therefore very individual stock selection based.

Offices in central London capable of capturing the predicted rental growth before 2009, due to their lease structure or refurbishment potential, are likely to be the strongest performers during the year.

RADFORD: KBC's view is that the UK property market in 2007 is set to produce attractive total returns of circa 10-12pc, which while healthy are below the 19pc returns recorded for 2006.

Although there is evidence that the debt-backed investors have retreated slightly due to the recent interest rate rise, there still remains significant demand from managed and unithised funds and other institutional vehicles. This weight of money is likely to result in slight yield compression throughout 2007 but we believe this is likely to reduce from 2008 onwards when total returns are forecast to be circa 5pc.

The market during 2007 will be driven by the office sector particularly in central London.

YEOMANS: After several years of double-digit returns, prospects of further yield compression are dwindling. We expect the market will revert to single-digit returns and for the income component of total returns to become the principal driver of performance, not capital growth. We anticipate returns of 7-9pc for 2007 and 5-8pc beyond that.

Should investors look to invest in overseas

properties going forward, and, if so, by what means and for how long?

BUNNEY: There is a very positive outlook for continental Europe over the next few years. We forecast a 12.7pc prime total return for Europe next year and an average of 11.2pc over the next three-year period. The fund of funds model is ideal to give an exposure from a relatively small investment to a range of core and core plus property funds from a selection of "best of class" funds and with geographical region representation.

DENNIS-JONES: As ever, what investors should do very much depends on their objectives. Are they investing in property for its absolute return prospects, diversification benefits, and/or its bond characteristics?

UK property is currently likely to be able to offer more opportunities to invest in lower risk bond style returns that are more likely to match the liabilities of a UK pension fund. However, there are still a number of sub-markets, like central London and south east offices, where good returns are forecast over the next three years.

Investing overseas can offer more diversification and potentially higher returns in certain countries or regions, but tax and currency risk may reduce or eliminate these benefits. Really, whether an investor should look overseas has to be made on a case-by-case basis dependant upon individual circumstances.

In terms of timescale and means, indirect investment through pooled funds and real estate investment trusts (REITs) provides a quicker investment timeframe, more liquidity, less management and potentially more diversification. This may be suitable for those investors more interested in the potential diversification benefits of overseas property.

Direct investment is more likely to suit the long-term investor who wants to create a very large bespoke portfolio and try to seek alpha through stock selection of properties. The time, risk and expense of finding people, creating and building the infrastructure, putting in place processes and procedures, obtaining individual country knowledge, and managing the people and properties, should not be underestimated.

FRANCIS: An increasing range of vehicles is helping to open international property up to UK pension funds. Most of the time, differing economic and market fundamentals offer investors diversification, and "bricks and mortar" funds in particular offer the chance to capture this benefit; funds of listed securities less so. However, many markets around the world have experienced high capital flows recently and do not necessarily offer better long-run returns than the UK currently.

HUGHES: Yes, generally investors should look to diversify their property portfolios overseas, as they would with any other asset class. We recommend investment through pooled funds rather than owning property directly, but are also highly supportive of listed securities. Although more volatile than direct property, in the longer term their close correlation with property market returns makes them attractive particularly because of their liquidity.

JORDISON: In our view, investment in overseas property is a means of gaining additional diversification, by accessing uncorrelated assets with the potential to diversify by countries, sectors and market cycles.

We believe the most efficient method of accessing overseas property is via a fund of funds, which enables investors to benefit from liquidity and diversification of managers, while gaining exposure to the characteristics of "pure" commercial property. The same cannot be said of direct property investment or exposure via REITs, neither of which offer a combination of these three features.

We anticipate attractive growth in the European commercial property market over coming years, particularly in the emerging market regions, and therefore see overseas property as a long-term complement to domestic exposure in an investor's portfolio.

MACLEOD: Yes. UK institutional investors should be looking to add an overseas property exposure to their property portfolio for a number of reasons. Not only do we anticipate better performance over the medium term from the overseas markets, but also the investment would serve as positive diversification and provide greater risk management. Recent analysis shows there is a low correlation between the UK and European property markets which will inevitably reduce the risk profile of the overall fund.

Without a significant war chest and the luxury of a long-term investment horizon, the recommended route in overseas property exposure for UK institutional investors must be through a portfolio of indirect vehicles, a single balanced fund or a fund of funds. The smaller fund, family trust or high-net-worth individual



should also look into the REIT options. The final option is the derivatives market which is grabbing all the headlines and could possibly provide the synthetic answer for a lot of investors if a deep enough market can be created and sustained.

MARTIN: Investors are attracted to overseas markets mainly by a desire to diversify and, at certain points in the cycle, the potential for higher returns. However, investing overseas brings with it extra complexity. Operating in different currencies, regulatory and legal environments, and in unfamiliar property markets, requires both time and expense to mitigate risk.

Furthermore, the case for investing overseas to take advantage of the cycle may be less compelling than in the past. For instance, yields in many parts of the eurozone are now at levels similar to the UK. With euro rates likely to rise in the coming months, the positive impact on eurozone property returns from the positive yield gap over debt costs may fall back.

NEWSON: The answer depends on the investor's ambitions. If the search overseas is for diversity, it is hard to disagree with the argument that the larger the potential investment universe the greater the diversity, (assuming a substantial fund size).

However, if it is to maximise returns, due to the belief that the UK market is strongly valued then the comparator of returns has to be evaluated along with location risk, possible enhanced management costs, and, of course, currency risk or hedging costs. The quality of management and local knowledge is, as always, key and our belief is that UK clients prefer to introduce overseas exposure through an indirect element (often run by the same manager) incorporated into their UK balanced portfolio.

RADFORD: The evolution of pan-European, and indeed global real estate markets, over the last decade means that investment outside domestic markets is now a realistic opportunity for pension funds.

The cyclical nature of European economies, coupled with their relative maturity, means that non-domestic investment by UK pension funds can provide a significant diversification

benefit. Caution should, however, be taken when considering this diversification benefit against total returns, which is maybe best shown by the UK returns versus Europe over the last five years, where domestic investment has shown the best returns.

Another key consideration for investing outside the domestic market is the ability to source suitable investment opportunities. Without a significant non-domestic team presence, we believe an indirect fund of funds solution will provide the necessary investor liquidity and gives access to the best local representation in the market.

YEOMANS: With the UK market seemingly at or close to the peak of the current cycle, those still seeking increased exposure to property are looking to Europe for value, or even globally as there is now tendency towards yield compression in Europe too. Most are considering collective investment schemes focusing on best-in-class funds of funds that provide well-diversified exposure and the most effective structure. Investment horizons are likely to be five years-plus.

When investing abroad there is always a currency risk to consider as well as the property risk. Currency risks can be minimised by hedging but the cost of this would dilute returns.

How would you manage a property portfolio differently when benchmarked to the Retail Prices Index plus 5pc per annum as compared to the Investment Property Databank? And are RPI plus 5pc targets achievable going forward?

BUNNEY: The principal difference is the ability to ignore the structure of the IPD universe. When IPD is used as the benchmark most fund managers are constrained from holding portfolio structures significantly different to that of IPD. These constraints can be set out in the mandate, or alternatively the manager can operate their own constraints by being a closet index tracker (benchmark hugging).

For an absolute return target a fund manager can legitimately demand and operate with much more freedom to buy possibly unusual properties and ignore their peers – there may also be a greater focus of securing high income returns.

Going forward, the general expectation is that property will deliver about 7pc per annum (nominal), which equates to circa 4pc per annum (real) in the long run. If we assume inflation is currently at 4.4pc per annum, a target of RPI plus 5pc does look aggressive in the short term but is probably more achievable in the long term.

DENNIS-JONES: We would focus more on assets with income streams expected to grow in line with RPI in the long-term (for example, retail and RPI leases) and which have lower residual risk (for example, retail).

In addition, having more liquid assets would make it easier to switch into cash/other asset classes if we expected that property was not going to hit the benchmark.

As to whether RPI plus 5pc per annum is achievable, the current IPD equivalent yield is 5.4pc, and for retail 5.1pc. Thus, on the assumption that rental growth continues to match RPI in the long term, and you invested in a market portfolio, this should be possible at an IPD return level.

However, current pricing on investments offering income streams that are likely to produce consistent RPI levels of return and have lower residual risk are in the 4-5pc initial yield bracket. So after allowing for costs, it may be difficult to achieve 5pc per annum real returns from such a portfolio.

FRANCIS: In equilibrium, we expect property to deliver 5.25pc above inflation and consequently we have actively managed balanced market-based portfolios to do so. Over the 20 years to December 2006, our own pension fund has delivered more than 8.5pc per annum above inflation.

However, after the recent exceptional returns and yield compression, property portfolios would need to do something different to achieve such returns today. Given there are no "free lunches", achieving 5pc real in today's market requires investors to take more risk, perhaps in the form

of "unbalancing the portfolio" and following the highest returning sectors disproportionately, or taking development and asset-management risk (which increasing numbers are).

HUGHES: To the extent that we do not expect an IPD UK benchmark to be significantly different from a return of RPI plus 5pc per annum over the course of the next couple of years, we would not materially alter the investment strategy we have for our existing UK Core Fund which targets this approximate level of return.

After the end of this year we think it unlikely that the UK property market, as reflected in IPD benchmarks, will achieve a return of RPI plus 5pc in the immediate years thereafter. But would a target return of that order potentially be achievable? Yes.

JORDISON: Such returns can be achieved by constructing a property portfolio yielding 5pc, with each of the leases of the underlying tenants structured in such a manner that rent reviews are subject to an upward-only minimum of RPI.

This would deliver RPI plus 5pc from income alone, with capital growth supplying a safety buffer for any potential pitfalls, such as vacancies or levels of high inflation where restrictions in the leases would mean RPI rental growth may not be achieved. However, it is important to stress that a 5pc yield may not always be possible in the commercial property sector, and capital growth may also be negative.

MACLEOD: The proposed benchmark reflects an absolute return target where there is greater emphasis placed on the delivery of total return across the investment period.

There is less of a requirement for a specific income return and the investment period would need to be reviewed over a longer investment hold period. In addition, we would introduce greater emphasis on the stock selection and be less dependent on maintaining an asset allocation that resembles the sector weightings of IPD or other relevant benchmarks.

A target return of RPI plus 5pc is certainly achievable, especially as we all now operate with more choice and across a larger geographical market with greater ability to use debt and other financial instruments.

MARTIN: RPI plus 5pc per annum is an absolute rather than a relative return target. Managers would be incentivised to design portfolios to achieve a given level of return irrespective of movements in the wider market. This would encourage an overweight position on the least cyclical types of property.

For the investor targeting the lower risk/lower return end of the spectrum, this may be the optimal choice of benchmark. The long-term track record of property, even adjusting for the lower income return available today, would suggest that RPI plus 5pc is an achievable target.

NEWSON: This very much depends on the market as at different points in the cycle RPI plus 5pc will exceed IPD and at other times lag. In 2007, the two are likely to be relatively close. Traditionally lower RPI style returns have been derived from lease/covenant deals which closer replicate the characteristics of bonds.

RPI plus 5pc should be achievable in 2007, but it will certainly be much more difficult to return than in recent times. One danger with absolute return benchmarks is managers are compared against the "higher of" when IPD is significantly ahead. In this regard, the client and adviser need to work closely to define the target.

RADFORD: Clearly, there is a huge range of indices published by IPD. The particular one chosen could result in a different approach, but generally speaking a portfolio managed to RPI plus 5pc over the next three to five years is likely to exhibit a higher risk portfolio than an IPD benchmarked fund. This target, however, is achievable but unlikely to be on a passive basis.

YEOMANS: Two such portfolios will inevitably be managed differently. While both ideally should have three-year rolling performance measures, these are particularly appropriate for an absolute

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returns manager, who is otherwise likely to be too exposed to the vagaries of market forces.

How can a positive return be generated if market forces are driving values sharply downward? In a market downturn it may be possible to protect overall returns by a tactical ability to invest in other forms of property (for example, CMBS or derivatives).

For relative return managers, none of these are necessary. They must simply seek to ensure their portfolio performance matches or exceeds that of the market. (Returns inevitably fluctuate over time.)

RPI plus 5pc would be a very demanding mandate. We know of people looking at RPI plus 2pc where investors have readjusted their target rates of return in view of market prospects.

How can property be an effective part of portable alpha in LDI strategies?

BUNNEY: This gives the opportunity to marry alpha returns with a fund that meets the liability requirements. For the first part, a fund manager taking a liability driven approach uses hedged assets to create a portfolio which will track the liability of the pension fund, as opposed to a property sector index like the HSBC/AREF IPD All Balanced Funds Property Index.

For the second, alpha return is first achieved by selecting stocks that will outperform a given index. For example, by selecting shopping centre funds that will outperform the IPD Shopping Centre Index.

In the portable alpha strategy, the client is only interested in the outperformance. He will therefore hedge out the benchmark tracking element with a total return swap, leaving the alpha to transport.

DENNIS-JONES: Portable alpha can be achieved through the use of a property derivative swap. The owner of a property portfolio can sell the IPD market total return, thus leaving the portfolio alpha. In practice, there are market inefficiencies which result in costs that may mean perfect portable alpha cannot be obtained.

The role of property portable alpha in an LDI strategy would only be for return generation rather than liability hedging. Property's low correlation with other asset classes would be beneficial as adding property portable alpha could enhance returns for little extra risk.

FRANCIS: The heterogeneous nature of property enables a range of return outcomes to be generated. For LDI investors it is able to provide secure, predictable, long-term cashflows, with inflation protection, which are weakly or negatively correlated with the other asset classes.

It gives a large measure of protection in the event of tenant default with a high recoverability of the principal and delivers better returns than bonds. We have been investing in suitable property on behalf of our annuity business for many years for these very reasons. It certainly should be a very important part of LDI strategies.

HUGHES: Property, like any other asset class, will always have a role for investors in terms of matching long-term liabilities, and, in many ways, its mix of a relatively high income return and capital growth potential is attractive. Capturing alpha consistently, when needing to match a given level of liabilities, requires an absolute return strategy which is best enhanced through wide diversification – in particular through arbitraging superior returns available from overseas property markets at different stages of the property cycle.

In the UK alone, prior to the development of a sufficiently liquid derivatives market allowing investors to short property going into a downturn, achieving sufficient alpha to provide a significant real rate of return consistently would be challenging.

JORDISON: A client could invest in a property fund

and simultaneously enter into a total return swap based on the property index which constituted the fund's benchmark.

The client would agree to pay the swap provider a return equivalent to the index, and the swap provider would agree to pay the client a return based on LIBOR, plus a spread (which is likely to be a return substantially in excess of LIBOR at the moment).

Any investment return generated by the manager of the property fund which is in excess of the property index would accrue to the client. Using this structure, the client would earn LIBOR, plus the additional spread, plus the alpha, less the charges.

MACLEOD: Property can be an effective part of an LDI strategy if the specific assets are let on long leases (over 15 years) or the portfolio's income is sufficiently diverse.

Typically, bond income provides a 10 year investment horizon which can be replicated by long-dated property rental income. Property should also provide greater capital growth over the longer period when compared to bonds.

Its ability to provide portable alpha is more difficult to judge. Property certainly can provide alpha, although we are not necessarily convinced that property can supply consistent medium to long-term alpha performance whilst also delivering a credible beta return that could be swapped.

Much of the beta return would come from the steady income stream, whereas the alpha would come from active management (re-letting, redevelopment, refurbishment, etc.). Too many of these opportunities will create lumpy performance and greater volatility.

We would also question the sustainability of property alpha as historic performance analysis shows that very few funds (less than 10pc) have been able to sustain 1pc outperformance against the market over periods greater than five years.

MARTIN: Property as an asset class is well-suited to a strategy that focuses on isolating alpha; beyond targeting particular sections of the market, managers also have the ability to work the underlying assets and add value in a way not available to bond or equity managers.

It is only recently that portable alpha strategies for property have become a practical option, with the increasing depth and sophistication of the derivative market. In time, with the increasing availability of sub-sector derivatives, it should become possible to focus even more closely on the "pure" alpha delivered by a manager.

NEWSON: Real estate has a place in an LDI strategy, but despite its hybrid bond/equity status it is incorrect to use it as proxy for other asset classes.

Property, in particular, has benefited from the declining bond yield, and while this is not a surprise, its insensitivity to interest rate changes limits its LDI attraction. Where it does fit very well though is to create alpha in a return portfolio that sits alongside fixed income.

RADFORD: Real estate investment was probably the original liability-driven investment strategy, with its income strength providing an important investment element for pension funds to meet their liabilities over the years.

In addition to this, real estate has, by its nature, a longer term investment strategy and also has historically provided a hedge against inflation.

Most real estate managers will say they are "active" or "adding value", but in reality many do not create value in excess of overall property market movements. With the end of comprehensive yield compression, those managers that make the best use of alpha could add significantly to total returns in their portfolios. To be able to deliver alpha on a consistent basis, however, requires real skill.

YEOMANS: Property can certainly deliver alpha. It is all about stock selection – the ability to

choose properties that will outperform the market. Unfortunately from this point of view, it is an illiquid investment which makes portability difficult. Some form of property derivative would be required.

As modelling techniques make it possible for pension funds to identify their cash requirements more precisely, it should be possible to structure products to meet those requirements. For example, the fixed income and equity components of property incomes theoretically could be divided up to provide securities with different investment characteristics.

What are your top two wishes for the coming planning system review, as announced in the Queen's speech?

BUNNEY: The essence is speed. We would like a more efficient planning system, with an early roll-out of a better, quicker, more clearly defined



process for complex and sizeable city/town centre regeneration projects. Also, in light of our infrastructure funds, we would welcome measures which speed up the consent process for these large scale projects.

DENNIS-JONES: More certainty in the planning system. The two key areas would be:

- A pre-determined and calculable development land tax replacing the current s.106 system
- A more European zone-based system which would more clearly define what is and is not permitted.

FRANCIS: If a planning-gain supplement is introduced, then contaminated brownfield land should be exempt. Failure to do this will increase the cost of urban development, reducing viability in many cases and putting additional pressure on greenfield sites.

The other should be a review of the current one month time requirement to sign section 106 agreements for large complex projects so it would be unlawful for authorities to add automatic refusal clauses to consents. This timescale can often be unrealistic for large s.106 agreements and creates an improper balance in the process when enormous sums have been expended.

However the best way of improving the system would be a non-legislative change, namely the proper resourcing of planning departments. Delays due to shortage of staff and lack of experience add cost to the process. Better resourcing in return for increased fee levels for an enhanced level of service would be very welcome.

HUGHES: Firstly, that the government abandons plans for a national development land tax, which, from past experience, would be extremely difficult to operate successfully in practice. Better than that would be to promote a more consistent system of planning gain for local authorities to apply on all new developments.

Secondly, for the government, through tax

incentives if necessary, to secure a consistently higher level of housing construction per annum to provide for a wide range of new, good quality, environment-friendly homes.

JORDISON: While the entire property industry would welcome a more streamlined, quicker and transparent planning system, we are still at quite an early stage and the final proposals are fairly hazy at present.

Threadneedle is not active in large scale development and infrastructure properties, because of the inherent risks associated with such large long-term investments. However, we do carry out quite a number of major refurbishments in the UK, and we are closely monitoring the proposals to see how it may affect this area of the market.

MACLEOD: Speed and clarity. Speed in terms of eliminating the uncertainty of how long the planning process will take.

A large part of this now results in pre-application discussions (even if some councils are now charging you for the pleasure) and trying to agree the detail pre-submission. The difficulty here is convincing the applicant to invest time/money doing it.

Clarity in decision making. There does not seem to be any consistency in decision making across the country and guidelines must help, even if it serves to explain the decision-making process to the applicant.

MARTIN: Firstly, increased certainty of planning permission. This is a challenge as all planning decisions are based on exercising judgement and hence we cannot have complete certainty. However, proposals that comply with development plans should be approved and not subject to the political whim of the determining committee.

Secondly, we would like to see a resumption of cross examination at development plan inquiries. The new system of informal examination of plans gives local authorities protection from their proposed policies being rigorously interrogated by objectors. The current presumption that the authority is right needs to be capable of detailed challenge.

NEWSON: Stronger protection of the green belt – to force real solutions to housing. Reverse any relaxation of consent for domestic extensions – to protect the streetscape.

RADFORD: Our wishes are for a faster and simplified planning system and the abandonment of the planning-gain supplement (PGS) proposals.

In respect of the former, local planning authorities should be relieved of some of their duties, including infrastructure projects and home improvement applications. More qualified staff would then be free to focus on their remaining activities.

If the government abandoning the PGS is not achievable, then a revised strategy for its implementation is a minimum as the current proposals are generally considered to be unworkable. The supply of land coming under development is likely to dry up at a time when most needed. In addition, the proposed diversion of the payment from the local community to the treasury is bound to promote controversy.

YEOMANS: The review has been long anticipated. Our sister company is a developer, and, with their assistance, we can help our clients benefit from redevelopment opportunities perhaps more than many other investment managers.

We want the review to deliver a faster, less complex and therefore cheaper planning system. We also hope the proposed planning-gain supplement is dropped. The review wants local authorities to recognise the economic benefits of development, but this proposed tax will make economic regeneration harder to achieve, and, or course, reduce value for our clients.