

PROPERTY PANEL



THE PANEL

CHAIRMAN: Graeme Johnston, senior investment consultant, Hymans Robertson



HYMANS ROBERTSON

Phil Ellis, head of property business development, Aviva Investors



AVIVA INVESTORS

Peter Balfour, partner, Cushman & Wakefield Investors



CUSHMAN & WAKEFIELD Investors

John Watkins, director of fund management, PRUPIM



PRUPIM

Andrew Smith, chief investment officer, Aberdeen Property Investors



Aberdeen

Paul Stewart, director, research & UK strategy, ING Real Estate Investment Management



ING REAL ESTATE

Nick Yeomans, managing director, Wilky Fund Management



WILKY FUND MANAGEMENT LTD

Andrew Grigson, associate director investor relations, UBS Global Asset Management



UBS Global Asset Management

Rob Martin, head of performance analysis and research, Legal & General Property



Legal & General

REASONS TO BE CHEERFUL

Panellists discuss the search for a silver lining in the face of falling sentiment, the importance of risk control in portfolios, their advice for Alistair Darling's Pre-Budget Report, and whether the British Retail Consortium's campaign on retail rents is a sign that traditional lease structures will come under further pressure

JOHNSTON: On some measures, sentiment got worse during the third quarter: property derivatives now seem to suggest capital values will fall 10pc over the second half of this year, 10pc in 2009 and do little more than stabilise in 2010. If that is too gloomy, what are the signs that should make us more optimistic?

ELLIS: Investor sentiment has weakened further in recent months in response to the financial turmoil and its likely impact on real estate investor and occupier markets. Investor markets appear vulnerable to a further tightening of credit conditions and occupier markets to weakening economic activity.

Sentiment is unlikely to improve until we get clear evidence that financial conditions are improving, and on this front there are a couple of reasons for guarded optimism. The first is the US bailout plan. While it is too early to judge whether the plan will be successful, it at least shows there is now considerable political will to find a solution to the crisis. The second is the easing of inflationary pressures, most notably the decline in oil prices, and the prospect of significant interest rate cuts that this raises.

BALFOUR: It is too early to judge the impact that recent events in the financial markets will have on the UK property market. A lot depends on how quickly banks recover confidence in lending to each other and how much room for manoeuvre the government has to stimulate the economy.

With the probable exception of lower base rates, there are very few signs of optimism in the "real economy". Disposable incomes and levels of corporate investment are falling, while unemployment is steadily rising. Against this background property continues to reprice, taking into account less positive views on rental values and prospects for growth. Investors are increasingly focusing on lease length and covenant strength.

The sharp outward shift in yields means that property yields are now at historically high levels relative to gilts, thereby offering a substantial risk premium. In some instances that risk premium may be unjustifiably large and represents an opportunity for traditional property investors with a long-term perspective to buy property without competition from debt-backed entities. With many of the largest pension funds currently under weight in relation to their stated allocations to property, they are likely to see yields of 7pc+ as a buying opportunity, where income is secure.

WATKINS: We believe the price correction that has already taken place means much of UK property is now "fair value" and, given prospective net income growth, is likely to deliver 7.5pc to 8pc nominal in the long term (although we see prices continuing to over-correct in the short term). However, it is equally apparent that current market conditions are such that despite this there are other assets offering better risk-adjusted returns short term. These "intervening opportunities" are likely to leave direct property struggling to attract capital for a while longer.

However, in a recent PRUPIM and Pensions Management Institute survey of pension funds, it was clear they had not abandoned property as an asset class, and nor should they or other investors. Indeed, on balance, they were looking to up weight slightly in due course.

As property goes "cheap" and the medium term development pipeline is squeezed, one can foresee a time, probably the latter half of 2010, when a combination of emergent rental growth combines with modest yield compression to deliver high single digit returns again.

SMITH: The UK is seeing a "double dip" slowdown. The first part of this, which started in mid-2007, was linked to the capital market repricing, but was not accompanied by any significant deterioration in letting markets or rental growth. The second leg reflects recent financial market turbulence, but combined with damage to the real economy, meaning rental values are also under downward pressure. In the short term there seems little doubt that 2008 will show the lowest calendar year return since 1974.

Although we expect a peak-to-trough fall in capital values of about 45pc, the UK market will be looking good value again relative to other asset classes and international property. The property yield margin over government bonds is already above its long-term average. Although occupier demand has been damaged by the collapse in economic confidence, the credit crisis has also helped to choke off the development pipeline, so there is a realistic prospect that once confidence returns, the market could improve quite quickly.

There have been some encouraging signs of interest in the UK market from overseas investors, as UK capital values have fallen far further and faster than for continental European property. In particular, German open-ended funds and, to a lesser extent, sovereign wealth funds and US opportunity funds have been buying in recent weeks. German open-ended funds have been buying central London offices, retail warehousing and distribution warehouses



in the last quarter, targeting assets with long leases and secure covenants. We expect growing interest from overseas investors going into 2009.

STEWART: Low transaction volumes characterise most global property markets at the moment. This lack of liquidity has already been accompanied by a 20pc-plus write-down in UK values, but barely anything elsewhere. This has left UK property much higher yielding (cheaper) in a global context. This has been further exacerbated to overseas eyes by the recent slide in sterling. Domestically, the re-emergence of the traditional 200bps yield gap to gilts also helps.

Development finance will remain very difficult to obtain, so an abnormally low level of development completions is anticipated for the next few years. With lower supply than in previous downswings, local occupational markets will be better placed to respond to the eventual recovery in demand. This could help property investors to see beyond temporary problems and could help property pricing to stabilise earlier than current derivative pricing anticipates.

YEOMANS: Unfortunately, the indicators became even worse after “Meltdown Monday”. The latest figures from the derivative market show a total return for 2008 of -14.5pc. And the final quarter could be as severe as the downturn seen in autumn 2007.

At least we might now reach the bottom of the cycle more quickly. Another slightly less gloomy factor is that sterling’s fall against the euro could help exporters, and thus go some way towards underpinning the value of industrials.

GRIGSON: Sentiment has been particularly negative during Q3, with September’s financial turmoil undermining the value of any forecast, whatever the sector. Amid this uncertainty however, it is important to remind ourselves of the reasons we invest in property.

Firstly, the recent volatility of equities has provided a reminder that the “bricks and mortar” aspect of UK property continues to provide a residual value in the event of tenant insolvency. Second, well let property provides a

strong income return, which remains attractive to pension funds.

With UK property yields rising towards their long-term averages, the sector will at some point provide a recovery opportunity for nimble investors.

MARTIN: The UK is clearly heading into a much more difficult economic phase – virtually all the leading indicators we monitor are pointing to a very challenging backdrop for occupier markets over the next 18-24 months. This is matched by conditions in credit markets that have drawn comparisons with the 1930s.

But yields for property now appear fair or even good value on a number of measures and with risk-free rates likely to fall, the relative pricing for the asset class looks likely to improve further. The investment market will lead the performance of the occupier market and we are looking for the re-entry of long-term UK equity investors in greater numbers; investment into the sector in recent months has frequently flowed into buying discounted debt; the next phase will be for this to focus on the direct market.

JOHNSTON: *Has risk control in property portfolios been important in the last year or has the downturn been too comprehensive? What has worked and what might need to be reassessed?*

ELLIS: This depends to a large extent on the type of risk being considered. However, we would argue that risk controls have rarely been more important. For example, at the portfolio level, if there is an explicit void limit then exposure to speculative development is of far more concern today than it was two years ago, as is covenant strength, where the economic situation focuses the fund manager on the protection of current income streams.

Diversification into a wider opportunity set including other sectors, high lease to value funds and overseas real estate, have all helped manage overall portfolio risk and provided enhanced performance potential. The speed of the downturn has meant that in some instances exposure to debt through indirect investment

has risen quickly while NAVs have been falling, which has affected performance at fund level.

But the downturn has also led to the re-evaluation of some long-standing measures. For example, where a mandate may have previously been limited to holding a maximum of 10pc of its value in cash, we might now discuss with clients treating that threshold as a minimum requirement.

BALFOUR: Having a robust risk control is always important, particularly during times such as these. One of the most potent in our view is the Investment Committee, which provides a qualitative review on a range of metrics on major decisions taken in relation to a particular mandate. Better governance is achieved by including members who are independent from the operational activities of the business. Attention is now much more focused on income quality and duration. Strong credit control processes and tools such as Investment Property Databank’s IPD Rental Information Service (IRIS) help fund managers identify problems at an early stage.

WATKINS: Risk control is always important for property investment funds and at no time more so than now. While it is true to say that all UK markets have tended to be driven lower by financial market factors, some markets are worse off than others. For example, being long to City offices or development activity would currently be very damaging to relative return funds.

In this environment, knowledge of a fund’s exposure across the lease length spectrum, and the prime-secondary spectrum, and its tenant exposures across economic sectors, are all marginally helpful in smoothing returns. Despite similar capital value trends in most markets, international markets are not entirely synchronised and diversification across borders will have helped smooth returns to funds.

However, risk control is not simply a strategic tool. There are many strategies that can be taken to de-risk individual assets in advance of troubled times.

PROPERTY PANEL

Continued from page 33

SMITH: The dramatic falls in capital values have been faster than anyone expected. This has highlighted the risks associated with gearing. While gearing was very beneficial to investors in a rising market, it can be equally damaging when the market goes into reverse. Highly geared indirect property funds have been under intense pressure, as the falls in property values have caused loan to value covenants to be breached, prompting forced sales of assets by these funds, sometimes at “fire sale” pricing, further damaging performance for investors.

In addition, many funds have frozen redemptions, often for up to a year, to enable them to manage the sales process to protect remaining investors. This has caused some to reassess the liquidity of indirect vehicles. There has been a reawakening of interest in the traditional ungeared direct property portfolio as a model.

STEWART: All portfolios have seen significant capital value losses over the past 12-15 months, regardless of risk control regimes. Leaving aside the obvious detrimental effects of too much gearing, those funds that have achieved the lowest capital value losses to date will probably have been those with the highest yield to begin with.

This is a convexity issue (in other words, an upward shift in yields of say 100bps has a bigger impact on property priced at 4pc than at say 7pc). Paradoxically those portfolios full of high-yield assets with shorter lease lengths, persistent void problems and let to poorer covenants, may well have actually done better over the last year or so. Conversely, these are now likely to suffer most as values continue to slide during a downswing in the real economy. The focus therefore is on asset management and the real world risks in a property portfolio – removing breaks and extending leases as well as ensuring voids are let to tenants with decent covenants.

YEOMANS: Risk control, in the form of diversification by sector and region, is and always will be important. Anyone whose sole exposure to property was through specialisation, City offices for example, would have fared far worse. However, the current downturn is so profound that it has been impossible to insulate any portfolio completely.

Holding quality stock with blue chip tenants is also important. Ideally, lessees would be well secured on long leases, perhaps with RPI rental uplifts. But even a scenario like this cannot be risk free. Lehman Brothers' landlord in Canary Wharf, whose rent was effectively guaranteed by AIG, must have felt pretty secure but look what happened.

Thinking more laterally, public sector tenants like local and national government bodies or the health service remain very secure because they are government backed.

Buying smaller lot sizes also helps because it spreads the risk for a given amount invested, and smaller properties also tend to sell more quickly, so they are more liquid.

GRIGSON: The changes in global capital markets over the past 12 months have proven why risk controls are so important. For example, basic risk controls such as limiting the exposure that a fund can have to other indirect vehicles have historically served investors well, but recent fund liquidity issues have shown that even these controls cannot adequately cope with change of the current magnitude.

We believe that the industry should promote widespread discussion of the liquidity versus price debate. Liquidity is a pricing issue; the

pricing of property companies and real estate investment trusts is a clear indication of the trade off.

The interests of investors must come first. They need assurance that the industry is taking the opportunity to ensure that our products continue to offer the advantages that property can bring to an investment portfolio, combined with pragmatic safeguards against any future extreme market movements.

MARTIN: The first phase of the property downturn was about a fundamental readjustment in pricing in response to an extreme set of events – a cyclical high in property prices meeting with severe restrictions on credit availability and a rapid reduction in risk appetite.

So the downturn was initially a systemic event, which risk control and diversification will not mitigate. But we are seeing more differentiation emerge in the investment market; in particular, a harsher economic backdrop will highlight the benefits of focusing on quality tenants and properties. So it is over the phase of the cycle that we are now entering when risk control measures will prove their worth.

JOHNSTON: Are there any measures relating to the commercial property market that Alistair Darling should announce in his Pre-Budget Report?

ELLIS: The key to helping the real estate sector through this downturn would be to accelerate the introduction of measures that facilitate the de-leveraging of the banking sector. With the reduced appetite for lending to both real estate investors and the corporate sector, real estate investment and leasing market conditions are likely to remain very weak for a protracted period.

Other measures that might be mentioned but which are unlikely to be changed are rates payable on vacant real estate and stamp duty on purchases. We would also welcome further positive incentives for environmental and sustainability policies.

BALFOUR: The changed rules on empty rates have certainly arrived at the worst possible time for the industry. With vacancy rates almost certain to rise across all sectors, landlords may decide that it becomes more cost effective to demolish properties rather than foot the costs for a prolonged period of vacancy. While in the medium term this may encourage development of obsolete buildings, it will potentially take functional property out of the marketplace and create stock shortages just as the economy starts to recover.

With a lack of liquidity being the most present issue currently, a reduction in stamp duty would also be a very welcome measure. Current transaction costs of approximately 5.5pc are a major disincentive to investment in a lower return environment.

WATKINS: We believe that Alistair Darling should announce in his Pre-Budget Report the restoration of the empty rates relief that existed before April 1 this year. This relief allows all unoccupied properties to receive full relief for the first three months; shops and offices pay only 50pc subsequently; and industrial premises receive full relief indefinitely.

SMITH: Lease structures always come under pressure in a downturn. Average lease lengths have fallen dramatically in the last 15 years, and the sharp economic downturn will further weaken landlords' bargaining position. Shorter leases, with greater incentives, will become increasingly common. It is in property owners' interests to ensure lease terms accommodate tenants' needs, but they also need to be efficient to administer.

Although landlords are beginning to accept monthly rentals on new leases, they are generally resistant to do so for existing leases without compensation to cover the loss of interest and the increased administrative burden. A move to shorter leases is likely to lead to increased vacancy rates in markets that experience higher tenant turnover as a result, particularly in the high street.

STEWART: The recent abolition of empty rates relief on industrial properties should be re-investigated. It is becoming clear that it has had unintended consequences. The impending occupier market slowdown means that some investors have talked of demolition. Rather embarrassingly for the government, this has even included Swindon Borough Council. It raises the risks associated with property development and therefore regeneration and may even deprive small businesses of affordable space.

YEOMANS: Levying rates on empty properties has turned out to be horrendously ill-conceived and ill-timed. He should reverse this. No doubt the chancellor had his sights on the caricature fat cat developer in his Bentley who apparently prospers by having empty buildings.

But the real targets are millions of pensioners whose pension funds are obliged to pay these charges and, of course, hard-pressed companies that cannot cut costs as they need to in a recession, as they still have to pay full business rates on any surplus premises.

The British Property Federation estimates half the £1bn the government wants to raise from this measure will be paid by occupiers and, almost certainly, this will lead to more company closures and redundancies.

The outlook for commercial property returns is negative for the next four years. So we need some radical pump-priming rather than the tinkering he did with the residential sector. How about a two-year stamp duty holiday to create an incentive to invest?



GRIGSON: Governments on both sides of the Atlantic have demonstrated how difficult it is to successfully and efficiently intervene in uncertain markets. The priority for the Pre-Budget Report should be to introduce practical and realistic measures that will reassure business and consumers that the government can help manage the downturn.

Specifically, the one measure that the UK government should announce to improve the prospects for UK commercial property is the restoration of full empty rates relief. Far from proving an incentive to landlords to let empty property, the current legislation distorts the market, promotes unnecessary demolition, is a disincentive to developers and is another indirect tax on the members of pension schemes.

MARTIN: The government should:

- 1) Repeal the legislation on empty rates, which is another tax on commercial property at a time when incomes are already being hit by the economic slowdown. It also hampers regeneration by increasing the risks associated with speculative development.
- 2) Reform the REITs legislation. In particular, removing the requirement for REITs to be listed will remove a barrier to the adoption of the REIT regime in current capital market conditions. Likewise, removing the distinction between investment and trading stock would help to develop viable residential REITs, fulfilling the government's aim of using the regime to support increased residential development.
- 3) Removal of the 4pc stamp duty on bulk residential deals where unit value is beneath the lower thresholds.

JOHNSTON: *Is the British Retail Consortium's campaign on retail rents an early sign that traditional lease structures will come under further pressure during an economic downturn?*

ELLIS: The BRC monthly rent initiative is nothing new, but in the current economic climate and with high-profile support it has attracted greater press coverage.

Responsible landlords with tenants experiencing real financial hardship will continue to offer short-term assistance, including flexible payment plans such as monthly rents. Existing commercial contracts should not be changed without some mutual benefit. Any tendency to arbitrarily adopt monthly payments should be opposed as being unfair and contrary to the original bargain freely entered into.

For new leases monthly rents could be agreed, but landlords should reasonably expect some compensation to counter the adverse cashflow implications and the additional administrative costs incurred in having to move to monthly invoicing/accounting. This could be by way of additional rent, and certain landlords are beginning to offer this flexibility to the market.

BALFOUR: In an economic downturn most landlords will want to maintain close contact with tenants and where there are genuine cashflow difficulties seek short-term solutions that may ultimately benefit all concerned. The market will need to determine on the grant of new leases the terms that suit both parties and the appropriate level of rent to be paid. We do not see why existing leases should be subject to change unless there are benefits to both parties.

WATKINS: Traditional lease structures have already changed as shown by the British Property Federation's recent data on the "average lease length". We do not foresee a return to longer leases and in our view terms offered by landlords will continue to be flexible.



SMITH: The very unpopular empty rates legislation introduced in April this year is having a damaging effect, and there is a strong industry lobby to have this repealed. The most recent development has been the rapid increase in demolitions – especially of large secondary properties – by landlords attempting to reduce their rates liability. It is now deemed more cost-effective to bring forward the demolition of property earmarked for redevelopment than to offer it to occupiers on a short term basis. There are also concerns that it will reduce development in times of economic downturn, reducing the choice for tenants, and potentially pushing up rents.

STEWART: It is clearly no surprise that the BRC is campaigning for monthly rents – that's its job. While some retailers are struggling and could benefit from moving to monthly rents as a temporary measure, some of the signatories to Sir Philip Green's letter are among the country's largest and most profitable retailers. Considering these same companies generally pay their suppliers six months in arrears, there is little sympathy for the campaign among pension fund landlords.

Furthermore, paying monthly once the market recovers will probably be perceived as an unnecessary administrative nuisance by the very same retailers. The property industry is obviously highly committed to providing flexibility for distressed occupiers, but ultimately such retrospective moves are contra to the basic tenets of contractual law.

YEOMANS: Leases have been getting more flexible for a number of years and this process will continue. But, in my experience, retailers negotiating a lease are more interested in the level of rent payable, maximising rent free periods and the extent of landlord's capital contributions to fit out costs. If improving cash flow through monthly rent payments is so important, that

is the time to discuss it rather than seeking to renegotiate via a public campaign.

That being said, if an individual trader is in difficulty in a particular location, it is in the investor's long-term interest to consider helping to keep the tenant in place, particularly when the economy is in poor shape.

GRIGSON: The British Retail Consortium's opportunistic campaign seems to ignore the bigger picture. The typical UK lease structure has evolved over time, adapting to the supply demand balance between landlords and tenants. A generation ago leases were typically for 25 years; now, a significant proportion of leases are very flexible, often requiring a commitment of only five years.

The retail industry has a history of squeezing suppliers, and any change to lease terms has a cost. Pension funds are significant landlords who are also dealing with the consequences of the downturn. If there is to be another shift of value from property owners to tenants, the increase in rent that should flow from such a change should be explicitly written into leases.

MARTIN: More challenging economic conditions will mean that both landlords and tenants will have to be more creative in agreeing leases – an optimist would see this as a benefit that comes from a period of market stress. However, this is frequently interpreted as a simple move to shorter leases with flexible terms for tenants – but landlords have to have the incentive to invest in their holdings to ensure they match tenants' requirements.

Perhaps the more enduring change to the lease relationship we are likely to see over the next several years is a much greater acknowledgement of sustainability concerns – with shared aspirations in terms of future-proofing and reducing energy/resource consumption.