SPR Newsletter November 2009

Coming soon…

SPR Annual Dinner and AGM
Thursday 12th November 2009

The highlight of the property research social calendar

1 Great George Street, Westminster

London, SW1P 3AA

AGM at 6.00pm

Pre-dinner drinks at 7.00pm

Dinner at 7.45pm

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This newsletter is edited by Tim Horsey. Please send any comments or suggestions to timhorsey@hotmail.com

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Coming Events

SPR Peer Review on the Impact of Designer Buildings

DTZ, 125 Old Broad Street, London EC2
Monday 23rd November 2009, 6-8 pm

An evaluation of the price impacts of signature architects

Authors/Speakers: **Franz Fuerst**, University of Reading
Patrick McAllister, University of Reading
Claudia Murray, University of Reading

Discussants: **Tony McGough**, DTZ
Dominic Smith, Land Securities
Rob Wilson, RIBA

The authors will cover the methods and findings of their paper which looks at whether commercial offices designed by signature architects in the US achieve rental and price premiums compared to those designed by non-signature architects. The authors used CoStar's national database and a combination of a hedonic regression model and a logit model to estimate the various rent determinants. First they examined the typical rental price differential and then the potential price differential over a set of buildings closely matched on important characteristics (such as age, size and location).

Please register to attend this event (ftrott@sprweb.com).

SPR/IPF Outlook for the UK Property Market

Allen & Overy LLP, One Bishops Square, London E1
Thursday January 14th 2010

As always, this will be the first big property event of the year, previewing what lies ahead for the commercial markets in the coming 12 months. The presentations will bring economic trends together with the property investment context to provide an authoritative view of prospects for the sector. Look out for SPR emails on this event to ensure your place!

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Another Look at the London Office Market

Venue to be confirmed
Wednesday February 10th 2010

Colin Lizieri will present the paper which won the Best Paper for Real Estate Market Analysis from the 2008 ERES conference. The paper, which won this SPR-sponsored prize, took the title "Asymmetric Space Adjustment in the London Office Market". It specifically focuses on the City of London, and was co-authored with **Patric Hendershott** and **Bryan MacGregor**.

The paper looks at the City office market over a longer time period than has previously been attempted, for the first time covering two property cycles. The analysis links the demand for office space, real rents and office-based employment levels.

The results from this modelling exercise will help to improve our understanding of rental adjustment processes in major office markets. In particular, the model emphasises the importance of the direction of supply and demand shocks - and the timing of those shocks relative to the rental cycle – in determining the speed and strength of the impact on rental adjustment.

The presentation will be followed by a panel discussion – participants to be confirmed.

Coming Social Events

Ice skating and New Year Drinks

Tower of London Ice Rink, London EC3
Wednesday January 6th 2010

The start of a new decade will be celebrated by the return of SPR's ice skating event. This year we have chosen the atmospheric surroundings of the Tower of London. We encourage you to register early, so we can estimate interest for attending the ice-skating event. While expenses will ordinarily be borne by the Society, a charge will be made for last minute cancellations. For those not willing to risk getting on the slippery surface, New Year Drinks will be held from the early evening onwards in a venue nearby.

Please register interest for ice skating with Fiona Trott (ftrott@sprweb.com).

2010 – SPR Golf to win again

Given the continuing and indeed increasing popularity of the Golf Day, the SPR Committee has decided that it should benefit from a larger slice of the Society's social budget next year. This will open up the possibility of playing on an even better course – most likely south of the river – and of enhancing the competition itself. Once again we welcome early entrants, so please put your – and your organisation's – name down now to avoid disappointment. As always, new entrants are especially welcome, particularly lady golfers!

Please contact either Michael Moran or Craig Wright if interested.

Michael.moran@moranrac.com 07833 538 507
Craig.wright@aberdeen-asset.com 07825 748 162

2010 – Summer Drinks

Look out for the invite to the summer drinks at the end of June and make sure you book your place in advance! Places are generally not limited, but given the nature of the event unregistered guests will not be allowed. For 2010's Summer drinks we are still to book a venue and the SPR would appreciate members' suggestions. Experience shows that this event presents a great opportunity for sponsoring, so please get in contact to secure early sponsorship opportunities.

Please contact Anne Koeman to explore sponsorship opportunities.
Anne.koeman@prupim.com 020 7548 6676

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Recent Technical Events

Unless stated otherwise, all meeting reports written by Tim Horsey

Property Derivatives Seminar I

Development of Property Derivatives and their Integration into Investment Strategy

April 20th, M&G Investments, Governors House, Laurence Pountney Hill, London, EC4

Paul McNamara of PRUPIM introduced this, the first of two SPR meetings exploring the maturing property derivatives market, with the prediction that it would lead to new roles for property researchers.

Angela Sheahan of IPD, the index producers who have provided the basis for UK property derivatives, described the scale the market has now achieved, with trading volumes in property swaps coming to rival levels of activity in the direct market. End-users have been responsible for around half these volumes, with banks, who have been looking to establish a presence in this market, taking the rest. She also highlighted the advent of exchange traded instruments with the licensing of Eurex early in 2009, though here activity levels have as yet been marginal.

The growing role of property derivatives for investors has been reflected in the emergence of positions within institutions with a specific responsibility for facilitating their use. **Phil Bayliss** has taken such a role in Legal & General's property division, and sees his function partly in terms of "debunking jargon". He believes that the complexity of these instruments is often exaggerated, and that their use in other asset classes means they are likely to find a place in the property sector. "Derivatives work well for large, capital intensive asset classes," he explained, "ideally with longer-term time horizons, market volatility and the possibility of hedging using the physical asset. It also helps to have a strong index. Property shares most of these attributes, and the argument for using property derivatives has now been won at Legal & General."

Bayliss described a number of the uses to which property derivatives are likely to be put within his organisation. These include increasing liquidity for open-ended fund vehicles and reducing sector allocation in parts of the market where it may be desirable to keep ownership of particular 'trophy' assets – even if sector derivatives have not yet become commonplace.

Will Robson, who plays a similar role at PRUPIM, highlighted the impact derivatives are likely to have for property researchers. "Property researchers tend to work in strategy, the area in which property derivatives are most useful," he said. "Fund management is all about performance and constructing portfolios, and in this process researchers are involved in view formation and structural recommendations – these should encompass property derivatives."

Robson believes that property derivatives may not yet have played a big part in researchers' lives because most trades have been at the all property level, and have been about high level asset allocation and hedging rather than solving problems within the property portfolio. Once sector property derivatives have taken off this is likely to change, as the underlying demand for such products must exist. Indeed, managing sector allocations within the portfolio is arguably the strength of the researcher, and using derivatives for this purpose could leave the fund and asset managers to concentrate on the areas where they are strongest – adding value to their property holdings.

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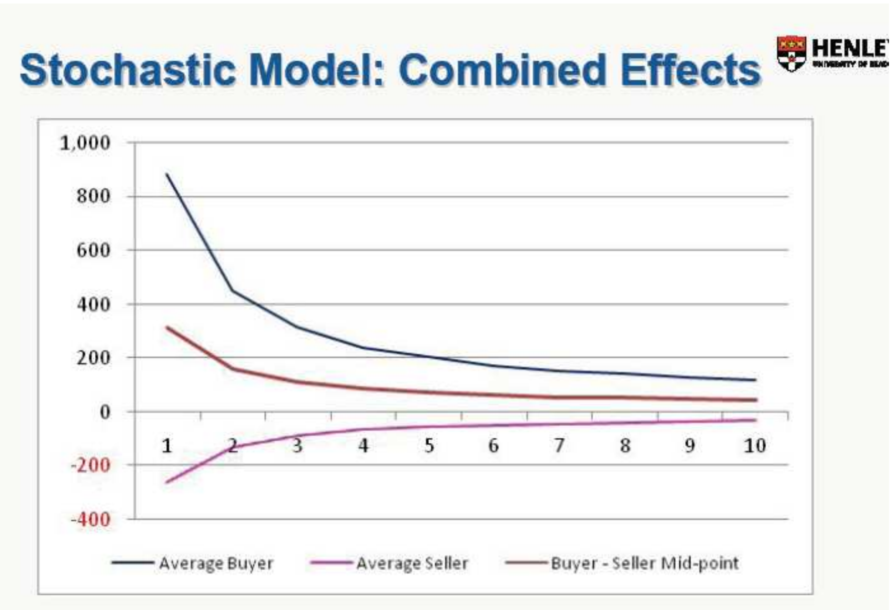
Property Derivatives Seminar II
What's in the Pricing? What's in the Future?
July 2nd 2009, Legal & General Property, 1 Coleman Street, London, EC2

The second of two SPR briefings on property derivatives combined a theoretical look at the pricing of total return swaps with an introduction to exchange listed products, now made possible by the involvement of Eurex in the UK market.

Christophe Cuny of Eurohypo began by exploring property derivatives pricing from first principles. He stressed that property itself has crucial differences from other asset classes which mean that derivatives pricing is bound to work differently. The aspects of liquidity, inertia and heterogeneity have already been well rehearsed. Nevertheless, Cuny believes there is a worthwhile academic debate to be had about how pricing should work in this market. His presentation therefore proceeded to discuss the relative merits of no arbitrage models, equilibrium/inefficiency pricing and incomplete markets pricing, and concluded with a discussion of the information value of property derivatives – one of the key areas of interest for property researchers.

Colin Lizieri of the University of Reading explored the information aspects in more detail, drawing on research being undertaken in collaboration with Gianluca Marcato, Paul Ogden and Andrew Baum. Like Cuny, Lizieri emphasised the differences between real estate, and for example equities derivatives, which mean that spreads are not likely to be bid away through arbitrage. He then went on to explore the interpretation of property derivatives spreads, discussing the notion that buyers and sellers of these products may be willing to cede a premium for the right to trade, thus creating a "swap window" around the zero neutral margin, within which the price will fall.



These spreads are likely to be influenced by transactions costs and execution times in the direct market, as well as appraisal and smoothing effects which will influence the indices on which property derivatives are based. Lizieri concluded by emphasising that derivatives prices are not forecasts, but are rather the outcomes of a number of different market factors.

The opening of the Eurex exchange to property derivative futures has created a new avenue for developing the market in synthetic property products, and should complement over-the-counter swaps which have led the way over the last two years. **Stuart Heath** of Eurex explained the particular advantages of exchange products in terms of standardisation, transparency and clearing – the latter particularly important with recent concerns about counterparty risk. Heath gave some illustrations of the transparency of exchanged based products with a comparison of the prices quoted on the exchange and brokers' estimates for property swaps. He also highlighted some potential applications including calendar spreads and relative value positioning.

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IPD *Real*World Conference 2009
in association with SPR

September 10th, Norton Rose, 3 More London Riverside, London SE1

Landlord and tenant conflicts 'cyclical'

Conference highlights as seen by James Wallace, IPD

Finding the optimal balance between lease flexibility and rental security was the centrepiece theme at this year's IPD *Real*World 2009 conference.

At the event – chaired by Reading University's Neil Crosby – delegates were told the relationship between landlord and occupier varied from 'win win' to one of inherent 'conflict', depending on the dynamics of the sector, the size of both parties as well as the phase of the property cycle and wider economic environment.

At an all property level, IPD Research Director **Malcolm Frodsham** said a comparison of average rental uplift on new leases in 2008 between lease renewals and new lettings was 11.4% compared to 6.3%. He told delegates: "Under these circumstances there is a natural interest in keeping tenants satisfied. The way to do that is through quality management, which from a landlord's perspective can be viewed as minimising their downside risk."

There are, however, exceptions. Frodsham told delegates: "In more bullish phases of the property cycle – where rental growth is accelerating – landlords can benefit from tenants moving on so that a higher rental income can be achieved on the open market. Inevitably, this creates conflict between landlord and tenant."

This raised the question for the subsequent panel session debate of whether occupier satisfaction is only a landlord's worry in recessionary periods. Delegate **John Story**, chair of the UK Occupier Satisfaction Index, took up the question, replying: "The OSI Index indentifies good and bad practices. Large landlords working closely with large occupiers are predominantly regarded as fair. It is at the smaller end of the market, where both smaller landlords and tenants operate that conflicts are most prevalent. This is particularly among landlords of small retailers who often accompany high service charges with a lack of responsiveness to tenant needs and little explanation for their actions."

At the extremity, CBRE Senior Director **Peter Barton** suggested that the relationship between the two counterparts in the retail sector could be challenging, with at worst mutually exclusive interests. Retail tenants, Barton argued, operate in a low margin environment forcing them to minimise costs while targeting high sales, which is in opposition to landlords' ambition for rental growth through upward-only rent reviews. This, he argued, required substantial compromise by both sides to dislodge, which could be achieved through sharing risk and driving consumer footfall.

Conference chair Crosby argued that ultimately the trade offs between leases and rents must be weighed up by landlords and occupiers themselves with as few regulatory impediments as possible. He added: "In Australia the adversarial relationship between landlords and occupiers is fierce - particularly within shopping centres where occupiers have no re-letting rights upon lease expiry." This, he said, was in a market with much more prescriptive legislation than in the UK.

The requirement for landlords to raise their quality of their management was emphatically highlighted by **Howard Morgan**, Managing Director at Real Service. Morgan told delegates that the more forward-thinking bigger landlords were making concessions by allowing tenants to pay monthly rents, engage in a green agenda dialogue with their tenants on a commercial basis and meet halfway in negotiations. "Real estate is essentially a hospitality service. And any industry which systematically fails to deliver what its customers want cannot be optimising performance."

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Hurdle Rates Briefing

September 29th 2009, Grosvenor, 70 Grosvenor Street, London W1

This meeting on a highly technical subject was very well attended, filling Grosvenor's lecture room to capacity.

The event revolved around the two presentations from **Rob Martin** of Legal and General and **Richard Barkham** of Grosvenor, both of whom explained how property hurdle rates are defined, calculated and used within their organisations.

Rob Martin described how L&G uses a combination of relative and absolute hurdle rates, the higher of which is generally applied for each property. Relative rates are calculated on a sector basis with forecasts for the sector as a whole provided in-house. Absolute rates combine a risk free rate with a structural risk premium and as well as an exceptional premium in some cases. Much of his presentation concerned the selection of the risk free rate: whether this should be based on gilt yields, long-term interest rates or equities yields, and whether nominal or index-linked. The structural risk premium is added to account for property-specific risks including liquidity, leasing uncertainty, transactions costs and sustainability risks. The idea of an exceptional risk premium has been introduced by L&G recently to capture a subjective assessment of macro investment risk as well as the uncertainty inherent in the other elements of the hurdle rate.

Martin emphasised that hurdle rates are intended to be used in collaboration with fund managers and not as a straightjacket. They are not designed to prevent risk-taking, but rather to provide a framework within which the risks being taken can be better measured and understood. In this respect the hurdle rate setting process needs to be "understandable, intuitive and manageable."

Richard Barkham set out the different approaches to defining hurdle rates that are being applied at Grosvenor, where three separate ways of obtaining such rates are used – though not always together.

A 'volatility approach' uses simulations of future market performance based on estimations of the risk inherent in both the market and in future cash flows to calculate the required level of return. A 'risk audit' approach builds up the hurdle rate from an assessment of the risks inherent in all the various aspects of the particular property type – for example tenant risk, rent risk and depreciation risk: these elements are combined to produce a premium which is added to the risk-free rate. And finally, a 'market structure' approach is used for assessing investment opportunities in various national property markets worldwide, a key consideration for multi-national investors like Grosvenor. This combines a risk-free rate with premia generated to reflect considerations such as market transparency and liquidity, business risk, depreciation risk and income risk.

Like Martin, Barkham asserted that hurdle rates need to have 'buy-in' from investment teams, but also stressed that they needed to be set independently in order to play an effective role in the investment process.

Robin Goodchild of LaSalle Investment Management commented as panellist that investors coming from different international markets were likely to have different expectations of risk and return and would therefore require different hurdle rates to be used when assessing investment choices. **Tony McGough** of DTZ, the second panellist, emphasised the importance of setting hurdle rates with a forward-looking perspective in order to reflect the relevant stage of the property cycle. The meeting concluded with a lively and wide-ranging discussion including many high level property researchers.

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Sustainability Research Briefing

October 1st 2009, Grosvenor, 70 Grosvenor Street, London W1

Grosvenor kindly hosted this briefing on research into property sustainability. The meeting ranged widely across construction waste reduction, saving energy in existing buildings, and the impact of sustainability on real estate performance.

David Moon of WRAP, the government funded Waste and Resources Action Programme, focused on the actions that developers should be taking to reduce waste and save money. The government's strategy for sustainable construction has set the headline target of halving construction waste going into landfill by 2012 – to be achieved through increased landfill tax, site waste management plan regulations, and voluntary agreements. British Land, Land Securities and Segro are among the 180 organisations that have signed up voluntarily to implement good practice in waste reduction – typically involving changes in policy and design, procurement and reporting. A critical element is getting waste saving integrated at the design stage. It is also important to ensure that data on waste is made available by all contractors.

Costing energy efficiency improvement in existing buildings has been investigated by **Richard Quartermaine** and **Hugh Mulcahey** of Cyril Sweett under the auspices of an Investment Property Forum (IPF) research project. The research, which was published in January 2009, found that relatively low cost opportunities exist for making CO2 reductions in existing buildings. The biggest scope for improvement lies in older buildings, as these are likely to be the least efficient in terms of energy use at present. The research also showed that it is possible to make improvements not only in vacant possession buildings, but also and perhaps more surprisingly in tenant occupied properties. This research looked across a wide range of building types common in the UK commercial market, assessed their baseline CO2 emissions, and then investigated the cost of bringing about CO2 reductions, in both vacant and tenanted scenarios.

Reducing the carbon footprint of investment property has long been a concern for **Paul McNamara** of PRUPIM. This has arisen from clear evidence showing that property is a major element of both the problem of, and the solution to, increasing CO2 emissions, since properties are a very major user of resources generally, and also because they offer the lowest unit cost potential impact on the problem. The motivation for investors to take on this agenda will, he believes, flow not just from increasing government regulation in the area, but also from the understanding that 'green' properties should perform better as investments – since they are likely to generate higher income growth at lower risk.

These arguments should, he believes, not just appeal to 'savvy' investors, who wish to improve their profits, but also to responsible investors determined to do what is right. Such responsible investors will be willing to embrace sustainability as long as it does not add to their costs – and any increased performance will be seen as a bonus. McNamara emphasised that investors would need to engage with these issues at a number of different levels due to the complex nature of property and property relationships. These he summarised in terms of the construction stage, the leasing stage, and in the relationship with tenants as building occupiers on a day-to-day basis.

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SPR/IPF Joint Research Meeting

Outlook for European Property 2009

October 21st 2009, Freshfields Bruckhaus Deringer. 65 Fleet Street, London EC4

This year's seminar on the prospects for European property took place somewhat later in the calendar than on previous occasions. As chairman of the meeting, **Charles Follows** of ING explained that the speakers would be focusing not just on 2009 – which should now be relatively easy to predict – but also on the prospects for 2010.

In another first for this meeting, the four presentations divided their attentions geographically rather than thematically, as had been the style in previous years.

Michael Haddock of CBRE began by outlining his view on the prospects for the three main markets of Southern Europe, Spain, Portugal and Italy, characterising them all as

'challenging'. But he emphasised that this similarity and the relatively strong correlations in recent market performance masked big differences in the underlying drivers of investment returns, both in the past and for the future. In Spain he sees great uncertainty remaining in the rental market, making it very difficult to determine whether investment yields, which have moved well above their long-run averages, as yet represent good value. The Portuguese market on the other hand may already have turned the corner, with office yields starting to fall, while Italian rental prospects should be fair as economic forecasts are ahead of the Eurozone average.

Jose Luis Pellicer of AEW, focusing on the 'core' Continental markets of France and Germany, believes that prospects in occupational markets remain relatively weak, despite the fact that their recessions have been less severe than expected. This relatively soft landing has meant that investment intentions in these markets have rebounded in a way that may lead to overheating, since the true level of risk has not yet been priced into yields. The outcome of this reaction, Pellicer thinks, may well be a 'double dip' in real estate returns.

The markets of Central and Eastern Europe have also fared less badly than was expected a year ago, according to **Petra Blazkova** of Jones Lang LaSalle, and their recovery now looks likely to happen sooner than elsewhere in Continental Europe. Yields are expected to peak in the main investment markets early in 2010, though secondary properties may well see further declines in value. Meanwhile, **Lars Flaoyen** of Aberdeen Property Investors considers that although the Nordic economies should outperform the European average over the next five years, rental prospects in the shorter term look weak. Here too values are expected to bottom out during 2010, even if rents continue to fall thereafter, as such declines should already have been absorbed in pricing.

The meeting concluded with a short debate on which markets would provide the best location for a capital investment of €50m in a European recovery fund. The Warsaw, Paris and Oslo office markets won out.

Recent Site Visit

Olympic Athletes Village
2nd July 2009, Stratford, East London

Some 20 society members enjoyed a viewing of the Olympic Athletes Village construction project on a glorious summer's morning. After a bus tour around the site guided by a member of the Olympic Delivery Authority, the group were able to survey the whole Olympic site from the centrally-located viewing platform.

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Recent Social Events

SPR Golf Day 2009
Aldenham Golf Club, Herts, Tuesday 23rd June 2009

Another successful SPR Golf Day was held at Aldenham Golf Club on a fine day back in June. The number of players was limited to 28, and an enjoyably informal pairs competition in the morning was followed by a more competitive and stimulating singles tournament in the afternoon. The competitors were sustained by coffee and bacon baguettes on arrival and a hearty lunch at the mid-day break in play. Congratulations and commiserations were shared into the evening on the 19th hole.

SPR Summer Drinks

Thursday July 16th 2009, Balls Brothers, Hays Galleria, London SE1

As usual, the SPR’s Summer drinks proved to be popular with members, as many joined for a couple of glasses and enjoyed some time for networking.
After the sudden move of Kwan Thai, on whose terrace the drinks were held in 2008, the SPR managed to secure an alternative location in the Hays Galleria. The drinks at Balls Brothers were well catered for and the mini fish and chips portions were an instant hit. Free of charge, the Summer drinks were kindly sponsored by CoStar.

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