



Financial Times Commercial Property Conference 2011



Introduction

Clare Hartnell,
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It's hard to think of a time when strategic thinking was more important. The commercial property sector is more complex and demanding than ever, and all the players have had to realign their expectations to meet the tough realities of today's market.

This is why Grant Thornton believes its sponsorship of the Financial Times Property Conference 2011 is absolutely crucial. Held at the Millennium Mayfair Hotel in London, this year's conference invited delegates from the UK and abroad to listen – and question – panels of industry leaders from the world of property, investment and planning.

The FT's Martin Wolf framed a gloomy, though probably accurate, forecast for the coming year. Growth will be slow, while the fiscal policies needed to get through these difficult times will be complex. As Peter Damesick, Chief Economist for CB Richard Ellis, pointed out, cash from non-European overseas investors is primarily being spent in London, with Paris significantly lower, albeit still in second place. It appears that banks will continue to selectively release their assets in a measured way over the next few years to get the best value for money. However, one thing seems clear – there is still high demand for property in the right places.

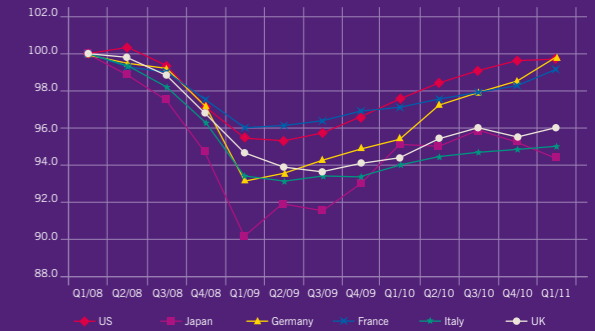
In fact, this year was a story of cities. The entertaining aside from British Land's Tim Roberts that “the riots didn't really help us much, did they?” belies the reality that London is still a place where opportunities can be excellent. It's plain economics. There are the necessities of supply and demand, and while not all of London – let alone the wider UK regions – is going to benefit, the fact is that people want and need good quality and good value property in the capital.

This simple economic viewpoint seems to be the most persuasive one, and by far the only sensible way to approach what's happening in the market today.

Where the market stands

Martin Wolf, Associate Editor and Chief Economics Commentator of the Financial Times, analyses the bigger picture facing commercial property

There was good news as well as bad in Martin Wolf's macroeconomic breakdown that began this year's conference. The FT's heavyweight columnist and CBE for services to financial journalism was perfectly placed to frame the commercial property market's greatest challenges for the coming year



The big picture

The good news is that aggressive monetary and fiscal policy, combined with the rescue of the financial system, created a relatively mild recession, though none of the major economies have yet returned GDP to pre-crisis levels.

The bad news is that the crisis has affected all of the world's biggest economies, which makes an export-led escape impossible. Monetary and fiscal policies remain dramatically abnormal and there is a long period of private sector de-leveraging and fiscal pressure ahead. In structurally slow-growing economies, weak growth of demand and chronic uncertainty are certain.

Global outlook

The world economy is a tale of two parts: slow-growing high-income countries and fast-growing emerging economies. The high-income countries face years of debt and austerity, except for those with export opportunities outside the high-income world. Emerging countries should be able to continue growing fast, but there are risks, such as too-easy access to credit and a big need for restructuring.

Europe and UK outlook

The threats confronting the UK and the eurozone include high private sector financial surpluses and fiscal retrenchment. If private spending does not rise as deficits are closed, there will be weak aggregate demand – even a new recession – and a risk of deflation. This makes low intervention rates from central banks and further bouts of unconventional monetary policy more likely.

Threats to the UK

The good news here is our policy autonomy, a devalued exchange rate and a relatively aggressive central bank. However, there is exceptional household debt, overvalued housing stock, a de-leveraging financial sector and a government implementing a structural fiscal tightening of 8% of GDP over five years.

Threats to the eurozone

While the eurozone has solvent core countries, there is still bad news. Weak private demand in core countries and huge past divergences in competitiveness will work against recovery. Structural current account deficits in peripheral countries and a reliance on now-disappeared private credit adds to the problems of rising credit spreads and weakening banks, as private and public debt interacts. There is a risk of catastrophic crises, and the break-up of the eurozone cannot be discounted.

Credit conditions

Governments will continue to try to cut deficits in an ongoing period of fiscal retrenchment. Weak economies suggest that this will lead to a looser monetary policy. We can expect to be in a low interest rate environment for many years, unless perceived riskiness explodes upwards, to France, the UK or the USA.

Credit supply may not be easy in these times. Banks have been badly burned and are also building up capital under market and regulatory pressures. Securitisation and “shadow banking” are still damaged, and so credit growth is likely to be weak for some time.

Today's market

Peter Damesick, Chief Economist EMEA for CB Richard Ellis, explains the current market trends for the UK and European markets

Parts of the property sector are performing very differently

London appears to be decoupling from the rest of the UK, where high-end stores and luxury retail are among the particularly local markets that outperform all others in the capital. Non-European investors, in particular, are focused on London.

The value indices across Europe are changing

If you look across different European markets, you find the picture for Southern Europe and Ireland one of declining values. France and Germany show signs of uplift, though not at any great pace. The Netherlands were not hit so hard in the downturn, but are showing new weakness today. Overall, activity showed a bit of a pick-up in 2009 and 2010, but that momentum is slowing in volume terms.

Investors are buying into Germany and its associated countries

The UK saw a drop in investment volumes in the first half of this year, as did France. Germany saw a rise, while virtually all other countries were down. Investors are avoiding countries with the greatest sovereign debt risk, buying instead into the better growth of Germany and its most closely associated Central and Eastern European countries.

The real estate outlook is for slow growth

We're in a slow growth environment. There is subdued occupier demand, while rental growth is limited to prime space wherever it is in short supply. In addition, development is restrained, with limited new lending and major refinancing needs.

The investor's perspective

"There is a need for long-term sustainable investments, and property is not the same asset risk as others. Large retail and industrial real estate is what we prefer, followed by office space, then residential in selected markets only."

Wenzel R.B. Hoberg, Managing Director & Head of Real Estate Investments, Canada Pension Plan Investment Board

"Large, liquid markets are where the investment is heading. The core space is overcrowded – what you need to be doing is taking 'near-core' and making it core. It's a tough buying market, but its very volatility throws up some interesting opportunities."

Simon Marrison, Head of Europe, Chief Investment Officer, LaSalle Investment

"We're not in a post-crisis world – we're in the middle of it. The risk is that we go back to the situation of '08-'09, where people do nothing. The markets are unusually polarised, with greater contrasts between primary and secondary asset classes."

Andrew Smith, Global Head of Property, Aberdeen Asset Management

The post-crisis portfolio

How has the approach of institutional investors changed since the crash? Our panel of leading investors discussed the evolving market and the new focus that has emerged

Property is still a worthwhile investment, even in the straitened circumstances following the financial crisis. While uncertainty lingers over the pace of recovery, the panel of the Financial Times conference were able to pinpoint some key areas that influence their decisions as investors.

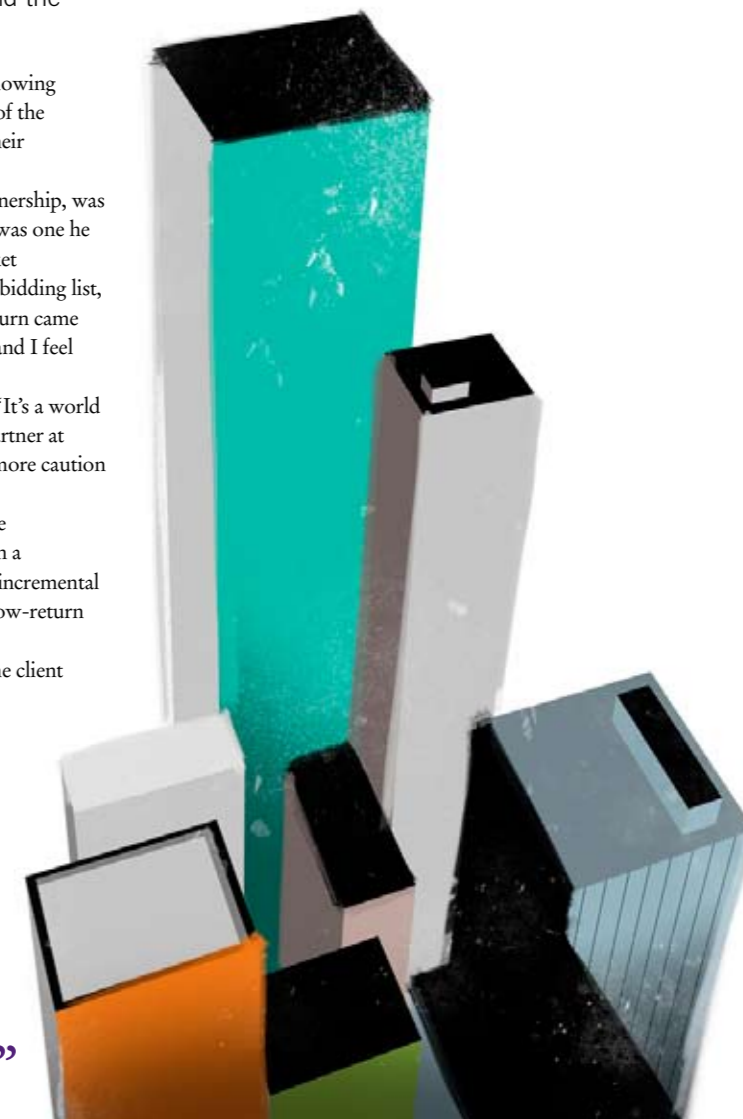
Malcolm Naish, Global Head of Property at Scottish Widows Investment Partnership, was able to project some brightness into the discussion, revealing that today's market was one he feels more comfortable in than the market of 2004. "We began to experience market dislocation from then, up to 2006," he said. "We were coming fifth or sixth in the bidding list, where we found it unusual to be uncompetitive with bidding. In 2004, 60% of return came from income yields, but by 2006 that had slipped to just 30%. That's risen again, and I feel that this is now a relatively appealing market for the long-term investor."

What has changed in the minds of the institutions is a new focus on the detail. "It's a world of greater caution and greater scrutiny of assets," pointed out Catherine Cook, Partner at Clifford Chance. "We're seeing significantly more transactions in Asia, but with more caution this time and a greater scrutiny of default risk and capitalisation."

This increase in focus was also emphasised by David Paine, Head of Real Estate Investments at Standard Life Investments. When investors look at a proposition in a low-return environment, he argued, they look at the entire process, as well as the incremental fees that can dictate how their investment will play out. The question is: will the low-return environment cause a demand for lower fees?

"There's pressure there, and we'll see that focus increase," Paine suggested. "The client demands you look at every part of the value chain – and it's your remit to do so."

"We're seeing significantly more transactions in Asia, but with more caution this time and a greater scrutiny of default risk and capitalisation"



Focusing on transparency in an opaque asset class

Proactively managing risk exposure and providing investment transparency is more than just a means to regulatory compliance: the survival of property investors depends upon it, says Matthew Nelson, Real Estate Investment Management Advisory Services, Grant Thornton

Industry players in the capital markets have engaged in a variety of initiatives to streamline transaction processing, such as setting payment messaging standards with SWIFT, Straight Through Processing and T+1 transaction settlement and the ISDA standards for derivative transaction documentation. These initiatives have dramatically reduced manually intensive processing and helped to achieve greater market transparency. The pace of change in communication standards and transparency in the \$29 trillion global commercial real estate market remains, by contrast, glacial.

The importance of transparency

While there are various reasons for the position in which the real estate investment industry finds itself today, there should be no question that improved transparency is required. Real estate has emerged as a mainstream investment asset class, with explosive growth in cross-border capital investment via direct equity and indirect asset-backed capital markets products. Within this context of globally distributed and highly leveraged real estate risk exposure, the bursting of the real estate asset bubble yielded disastrous consequences for many investors and lenders.

A lack of investment in market transparency and risk management has allowed asset performance data to remain siloed, tangled, disparate and error-prone. Data inconsistency, incompleteness and fragmented information flows mean that investors are making business decisions with a limited grasp of the far-reaching financial, risk and compliance implications.

While the boom years for real estate allowed this situation to proliferate, today's market pressures on asset valuations and profit margins,

combined with a tsunami of regulations, make appropriate risk management and true investment transparency a prerequisite for attracting and retaining capital going forward. Successful investors will be the ones who can retrieve accurate data, translate it consistently and present it according to user requirements.

Regulatory implications

Investment transparency and the effective management of risk is at the heart of the Alternative Investment Fund Management Directive (AIFMD). Once legislated in EU countries, the AIFMD will particularly weigh upon real estate investors. Because asset, tenant, sustainability and carbon emission data is gathered at the grass-roots level from disparate parties, real estate investors struggle with the daunting task of data aggregation, cleansing and manual manipulation to even begin to report on performance, or to make asset and portfolio-level decisions. When quarterly investor and creditor reporting is absorbing tens or hundreds of man hours across an organisation without any

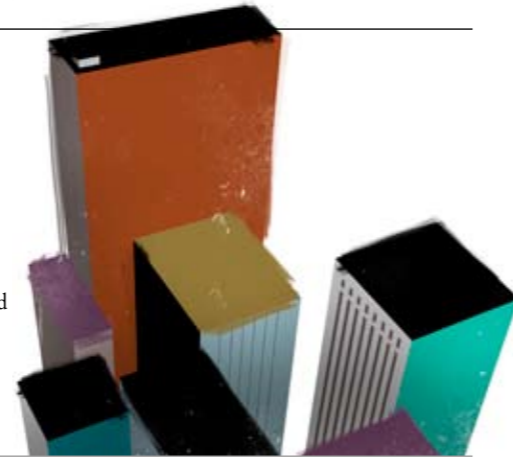
assurance that the numbers are correct, increased disclosure becomes an exponentially more risky and error-prone endeavour.

In a post-AIFMD world, institutional investors will have little choice but to allocate capital to investors who can provide requisite transparency and thus demonstrate they can manage risk both at the portfolio and at the underlying asset levels.

Complacency is not an option

Real estate investors should understand their preparedness for AIFMD and commercial implications of non-compliance. The easier one makes it for limited partner (LP) investors to comply with AIFMD, the more attractive one becomes in the market.

The winners in this market will be the ones who ensure their ability to access and manage clean data, not only for investment decision-making purposes, but to enable them to identify, measure and manage the financial risk inherent in their portfolios on behalf of demanding shareholders and LP investors.



The future of real estate finance

What will 2012 bring for those looking to finance commercial property? In a lively panel discussion, delegates from banking and investment firms underlined the sensible caution in the sector

“We’re all being driven in one direction at the moment”

Banks are not going to assume growth for some time, so they have to go about this in a careful way, not dumping their property. They will pick and choose, selling dogs, minimising losses by holding on to good assets. Banks do move in a herd instinct. We’re all being driven in one direction at the moment, and it’s a crowded place.
Richard Dakin, Managing Director and Head of Corporate Real Estate, Business Support, Lloyds Banking Group
Harin Thaker, Head of Real Estate Finance International, Deutsche Pfandbriefbank AG

The aim is to provide intensive management to restore health into businesses. Banks haven’t been releasing much property on to the market. We look at it in three ways. Firstly, most banks want to restore customers to financial stability. Secondly, properties are still being sold, consensually and through receivers. Thirdly, we’re seeing a workout of assets, both through customers and dedicated relationships with responsible partners in retail or residential.

However, banks don’t necessarily control these assets. There has to be a staged process to get rid of them. The receivers are more often in control than the banks. We did £6 billion through receivers last year, so equity is coming on to the market. It’s getting that equity to the regions that need it that is the challenge.

“The forecast is flat for property growth, but this makes things interesting from a UK perspective”

“I’d like to see the phrase ‘funding gap’ banned”

The expectation that banks should offload assets to strip debt is still there, but banks actually are doing a good job of managing those portfolios themselves.

Even three years ago, banks had a certain level of sludge in the tank that takes a while to get rid of. There will now be more product for buyers at sensible prices as banks gradually offload at a good rate.

Right now, I’d like to see a universal ban on the phrase “funding gap”. You have to see what there is now and in the future – it’s not about forcing parties to do what they don’t want to do.

The equity says, “I’m short of money to buy.” Well, you either don’t buy, or you get it elsewhere for less. Leading people to believe that banks will come back and lend 70-80% of value isn’t helpful because it’s not living in the real world. That’s just the way it is.

Paul Rivlin, Joint Chief Executive, Palatium Investment Management

Sustainable property and construction

Sustainability is the key to future value, says Nathan Goode, Head of Energy, Environment and Sustainability at Grant Thornton. Developing commercial property that is both resilient to environmental risk and efficient in its construction and day to day running is where this value can be found

The property and construction sector undoubtedly has a large ecological footprint, particularly through development activities and the operational management of assets. The UN Environment Programme estimates that the built environment accounts for around 40% of all energy consumption, 30% of raw material use and 25% of solid waste production. But how critical of this footprint are the people investing, developing and occupying in property?

Changing occupier requirements

Research in 2009 by the EC found that 84% of international occupiers believed sustainability would be critical to their business. This trend is likely to continue as more organisations wish to align their real estate occupation strategies with their corporate responsibility commitments.

Building ratings

BREEAM and other ratings provide a useful tool to benchmark sustainability credentials. While building ratings alone do not deliver sustainable buildings, they can enable better tracking and evaluation of financial performance.

Flexibility

Buildings that are adaptable and suitably located are more inherently sustainable as they typically have longer useful lives. We see this as an important future determinant of asset value, as such buildings typically require less investment to cope with changing use.

Weather vulnerability and climate change risks

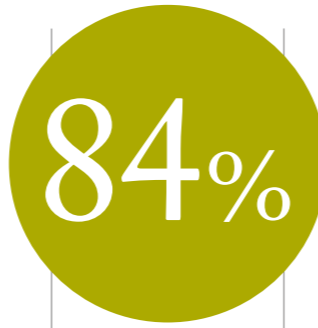
The resilience to risks associated with climate change has the potential to impact materially the ability to generate investment returns through increased maintenance costs and rising building insurance premiums. Risk-modelling techniques provide a method for evaluating the risk associated with owning assets in locations where extreme weather can physically affect an asset.

Energy and water efficiency

Energy and water efficiency is key to effective property management; cost savings from efficiencies can be passed on to occupiers via reductions in service charges. The installation of smart meters and water-saving devices across the property portfolio can improve measurement and monitoring capabilities, as well as reducing the carbon footprint.

Waste management

There needs to be a focus on managing waste arising from property and construction activities. As the cost of disposing of waste to landfill outstrips the cost of recycling or reuse, the business case for alternative waste disposal routes is clear.



of occupiers believed sustainability is critical to their business

Source: European Commission report, 2009

The drive for office development

“Demand, especially in the prime of central London, is still there. It’s a dynamic, liquid market that’s a good bet for medium- and long-term investment. Part of the reason is that occupiers are driven towards higher-quality assets, and obsolescence is driving the market”

Robert Noel, Managing Director, Land Securities



What does the built environment use globally?



of total world energy consumption



of total world raw material use



of total world solid waste



of global CO₂ emissions

Source: UN Environment Programme

The Olympic legacy at Stratford

The socioeconomic legacy of the Olympics is our real driver, not just the event in 2012. We want to see the regeneration of the entire community for the benefit of the people who live there. That means physical connectivity, like bridges and stations, but also social connectivity that comes from policies and programmes. There’s perhaps a 20-year programme set for East London, with the DLR extension, Barking Riverside and Tilbury Ports developments – long-term schemes that contribute to the ripple regeneration effect.

Duncan Innes, Executive Director of Real Estate, Olympic Park Legacy Company

Market predictions

Seeing the way ahead for commercial property is crucial. Even in a flat market there is opportunity, especially one that has been unsettled. Chris Giles, Economics Editor of the Financial Times, spoke with four leading figures in commercial property to find out where they believe we're heading

Gerald Kaye Development Director,
Helical Bar

Anuj Mittal Director, Angelo, Gordon Ltd

Chad R. Pike Senior Managing Director
& Co-Head of Real Estate,
The Blackstone Group

Jos Short Executive Chairman,
Internos Real Investors

Is property still attractive compared to other asset classes?

JS: Here in the UK it's open, there's a good legal system and it's liquid. There are pockets of the market that are underpinned by robust income streams. Markets are volatile and bonds are expensive. It's not gold, but it's a defensive investment as long as you're picky about what you buy.

GK: It's a good diversifier. Bonds are low and you get nothing in the bank. At least in property there's been capital growth and a return.

Did you see any effects of quantitative easing on property?

GK: Not really. I think people are just hoarding cash, despite getting a very low return. They're just sitting on it.

Is there anything that the government or market can do to make the regions more attractive for investment?

AM: We're looking at the regions, towns and businesses that are doing well. There are towns that are strong, and properties that are good in those towns. You need new buyers that are motivated to buy and invest in properties first, which isn't happening because you've got some very passive owners who are just sitting on it for the foreseeable future.

So what in the game has changed for you?

CP: There's less discretionary capital. The game is changing where money is important, people with cash can do the deals, but successful firms will also be about services with incentives. At the moment people aren't taking that much risk, just squirreling the cash.

What do you see as the threats on the horizon?

GK: We've heard a lot about London as the place for investment, but I'm worried about the regulatory threat to London coming from Europe. There is the transactional tax that Europe wants to bring in, for example. We're losing an advantage if we lose the success of London.

CP: The worst scenario for me is a full-blown European banking crisis where they can't get the capital and have to nationalise the banking debt.

Chris Giles, Economics Editor of the Financial Times, sums up the leading issues from the panels

Our first speaker, Martin Wolf, said he couldn't see how the eurozone could stay together, and he couldn't see how it could split apart either.

On the face of it, he wasn't exactly optimistic about the global economy. That set a rather difficult backdrop for the rest of our discussions.

Another key issue was in examining investor perspectives. The conclusion was that in most respects the markets are going sideways in commercial property, but that some major European cities still had good prospects.

During our market predictions panel, we conducted a show of hands to gauge the greatest threat. People think that a European banking crisis is what we should be most frightened about, an intensity of threat that underlined Martin Wolf's analysis.

On a brighter note, what are the real opportunities ahead?

JS: A number of big funds are over-levered and need equity. I would be looking at these vehicles that are coming to the end of their lives, things coming on the market that are complicated, where you can negotiate interesting deals.

CP: I'd be looking at deals on five-year asset loans that are coming back on the market, maturing and needing refinancing.

AM: The real opportunity we have is time. The further we get from the crisis, the more bankers are happy to lend.

What can be learned from the conference?

Optimism may be in short supply, but demand remains in particular segments, according to our panels – if the economy and banking sector allow investment to push the pace of change

It's important to remember that the financial crisis has bitten every sector of business. In commercial property – and in specific regions – there have been some signs of uplift, however gradual that may be, as Peter Damesick pointed out in his introduction to our panel on investor perspectives.

As the sluggish – some would say sideways – market continues, it forces innovation and excellence. Low volumes of property and a tougher banking sector mean that deals are only available for those who have the trust of their counterparts and experience of delivery. The banks are preferring to manage their assets in a controlled and value-driven strategy.

The highly specific niches that are proving most profitable

were addressed at length by Malcolm Naish of Scottish Widows Investment Partnership. In the UK market, as well as some larger European cities, the focus is now on the prime locations and better quality investments. "This is a relatively appealing market for a long-term investor," underlined Naish.

While Martin Wolf's opening speech may have vocalised the concerns of most delegates, suggesting that growth over the next four years may still be in question, there was still a return to the idea of opportunity. In office development, retail property and the legacy framework of the Olympic Village at Stratford, glimmers of plain economic sense could be seen, matters of supply and demand for excellent value. These opportunities, though certainly London-centric, are still there.

Quotes from delegates

My concern is that we see a continuation of very low volumes in the market, driven by the inability and lack of disposition of the banks to offload assets. I think there is a role for us to play as opportunistic investors, but if the banks don't play their part then we're still just waiting for them to make their moves.

Adam Bryer, Partner,
Exmoor Group

In our part of the world demand is picking up, which I think was reflected in some of the panels here today. In Central and Eastern Europe the market is certainly picking up a bit. That's OK, but it's clearly not back to the good old times – it's still a difficult market.

Marian Herman, Director of Investment Management, HB REAVIS

Trying to raise more than €100 million of debt is tricky, even on the very best property, because no single bank can cut a cheque for that amount.

We can find assets, but the only way is to be local and to have teams going off the beaten path of your pure international investors who don't always have teams on the ground.

Simon Marrison, Head of Europe, Chief Investment Officer, LaSalle Investment Management

There is debt there, but it's very selective according to your relationship.

It's probably the banks sticking to wanting to work with people they know, with a product that they like. Prime is still being pushed up in value terms, which is essentially central London, while all the rest will definitely go down in the short term.

Sally Doyle-Linden, Chief Financial Officer, Mountgrange Investment Management LLP

There's an implication in the way people refer to the "funding gap" that the banks have a duty to carry on lending at the same level as they did before. And that strikes me as nonsense. Is that gap to be solved by the bank being morally obliged in some non-commercial way?

There may be a problem, but it's not an injustice.

Paul Rivlin, Joint Chief Executive, Palatium Investment Management

You won't get speculative funding in the North West. Contractors are getting prepared to fund the contracting phase of development, and some pre-development expenditure. The big contractors have got strong balance sheets. There's not a lot of work for them out there and they're ensuring that they have some construction margin in the future.

Jonathan Cross, Group Financial Director, Ask Property Developments

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