Grant Thornton

Financial Times Commercial Property Conference 2010

Introduction

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The game has changed. The commercial property sector has experienced a sequence of events that has led everyone in it to question their strategies and their future expectations. Bringing together the world's leading authorities, investors and developers to thrash out a road map for the market has never been so crucial.

Grant Thornton was proud to sponsor the Financial Times Commercial Property Conference 2010, held at the Millennium Mayfair Hotel in London. It was an international affair, with delegates from South Africa, Japan and the United States flying in to have their say and contribute to this fascinating series of panel discussions.

Some of the speakers, such as the FT's Martin Wolf, weren't afraid to say what everyone was thinking: the Asia/Pac markets are stronger than the more developed nations, and that our growth will not return to anything like its old level. There were insightful comments on the prospect of the double dip from several panellists, of which you can read more inside.

Among the doom and gloom, we heard several voices that have scrutinised the market to look for good news. Among them was Philip Clark of AEGON, pointing out that our banking system is no longer in panic mode; we're in a more measured period of activity, which can only be for the good.

We were also given advice about the state of various overseas locations as potential investment areas, and new ways to source capital in a system that shies from debt. Among my own clients, I haven't seen any finance being offered in excess of 65% loan to value. That causes problems as there is a significant equity gap to plug. Added to this, arraignment fees are increasingly being added to interest rates, making debt finance more expensive.

With all these obstacles, there is still a way forward – as the cast of innovative, strategic minds at the conference proves.

Where the market stands

Martin Wolf, Chief Economics Commentator of the Financial Times, gives a macroeconomic view of the current financial climate

Who better to set the tone for the conference than Martin Wolf? The FT's lead commentator and CBE for services to financial journalism had plenty to tell us about the recovery from the global crisis. He provides the background to world events and the challenges faced by the commercial property sector

The good news for the UK is…

We managed to devalue. We have some inflation, but that gives us some prospect of export growth, one of the two main sources of growth from the government point of view.

We have a relatively aggressive central bank. The UK has far and away the largest household debt overhang in the G7. Now values are recovering and the banks are stronger, will we see a rush of foreclosures and forced sales?

We are going to have a progressively deleveraging financial sector. We will also see a structural fiscal tightening of 8% of GDP over five years. This is the biggest structural fiscal tightening in the G7 and compares only with countries that really can't sell their bonds any more – and the UK is not in this category.

In terms of fiscal retrenchment

My guess is that governments are going to do less than they promised. But they're still going to do quite a lot and we will have a lot of trouble in the process of trying to balance the deficits.

I see deflation in the short term. And maybe in the very long term, say 10, 20, even 30 years, we'll have an inflation problem, but there's no sign of that as yet.

We have a low interest rate environment now, and certainly for government bonds and central banks official rates will be very low.

We're going to see more unconventional money policies. Both here and in the US

In terms of credit supply, the banks are badly burnt. They're building up capital under market and regulatory pressures.

But even though central banks are pouring in money, the policy isn't really working and I expect that to remain the case for some time.

Questions of property

What are the main questions the sector should address? Jonathan Ford, Associate Editor and Chief Leader Writer of the Financial Times, named several in his opening remarks as Chair.

Governmental actions on debt

As western nations tackle ballooning sovereign debts with fiscal consolidation and legislation, is there a chance that these measures may tip European economies back into recession?

Public net borrowing

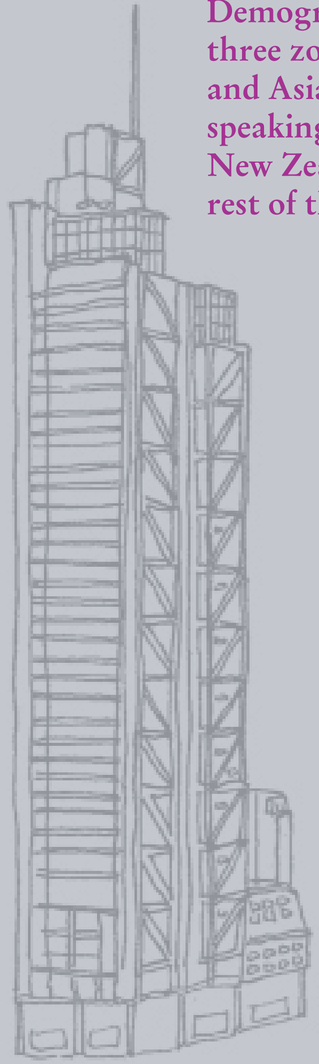
Even if there isn't another economic collapse, structural adjustments in UK public net borrowing will average 1.4% a year, which will be some headwind against growth in the property industry.

The debt overhang

During the crisis many banks simply rolled over under the weight of real estate debt because the losses were too large to take on their balance sheets. Now values are recovering and the banks are stronger: will we see a rush of foreclosures and forced sales?

How is the market changing?

Demographics paint a picture of a rapidly changing world
that property must respond to – the question is how



Demographics show that population growth will occur in three zones. Africa will have the highest percentage growth and Asia the highest numerical growth, while English-speaking nations – the UK, US, Canada, Ireland, Australia and New Zealand – will also grow, thanks to immigration. For the rest of the world, it's a sober picture of decline or stasis

What do these forecasts mean for the property sector? The UN predicts that urban areas will absorb all of the population growth between now and 2050, says Leanne Lachman, President of Lachman Associates, an independent New York-based real estate consultant company.

"All these people need new houses. The bulk of it is at the very low income band, but demand from the middle class is rising dramatically, particularly in developing markets. With the workforce comes a demand for housing, for retail, and a huge requirement for budget hotels in working environments."

Finding the right location in these cities is key, but developers are now feeling the presence of another factor in their work – environmental and energy needs. It's a point emphasised by Ricky Burdett, Professor of Urban Studies at LSE: "Buildings consume 50% of world energy," he says. "But there are sustainable models that can also be profitable. Look at Seattle, Portland, Copenhagen, Singapore, some of the Chinese new towns in the Pearl River Delta, Hong Kong – these are examples of more sustainable, affordable, smart buildings that produce the sorts of environments which, in five or 10 years' time, will be the only way that we can ever be moderately sustainable."

Building for these new, fast-growing populations in sectors that they'll actually need – middle and low income housing, with retail and businesses to service them – is key. While sustainable, greener development is dawning as a cost-effective strategy globally, it's the markets with existing stock that can be retrofitted – such as the UK – that will see growth, as properties are squeezed for value over the long term.

The Asian markets

Risks and rewards are still linked when investing in Asian commercial property, but understanding your market well can reduce uncertainty and uncover true value. That was the message of Bromme H Cole, Managing Partner of Hampton/Hoerter LLC, speaking at The New Markets panel of the conference. **"Asia can be a scary market with tangible risks – political, social and economic,"** he points out. **"There are ways to mitigate them. There are real incentives, too; take Vietnam, which has 30 million workers, who need housing in cities. The less developed parts of Asia weren't affected by the crisis so much because their financial systems are simpler and more insular."**

Sustainability: the future begins now

Has the financial crisis been the making of greener property investments?

There are more than 16,000 registered commercial green buildings in the UK, says Professor Nils Kok, Professor in Finance and Real Estate, Maastricht University. "An increase in regulation has led to growth of supply," he explains. "Large corporate tenants want to be in green buildings." While the US leads in this area, with 28,000 registered commercial green buildings, there is a movement across the UK and eurozone for more, and the legislation to back it up

"Clients have a cost-down strategy in the face of the recent crisis," adds Marlon Huysmans, Director of Sustainability at OVG Real Estate, a green specialist. "We've seen a flight to quality, and sustainability is one of those qualities in demand."

As with any property market, the greatest factor is economics. Will the investor trade green for returns? Low operating costs and legislative advantages are incentives on the table, but building new isn't the whole story.

"We're in a low growth economy," says Tim Mockett, Managing Director of Property, Climate Change Capital. "The real focus is on retrofitting existing building stock.

"We don't even go near renewables; our firm looks at lighting, heating, cooling and monitoring to make green efficiencies that really pay."

Whether investing in new or retrofitting old, the panel of Giving Sustainability the Green Light agreed that sustainability is a worthwhile aim for profit alone.

> "We've seen a flight to quality, and sustainability is one of those qualities in demand"

How CEOs can excel

Risk is not the key word in terms of what CEOs are focused on, says Serena Althaus, Managing Director Europe of Ferguson Partners Europe. **"There's a switch back to the old values of how to bump a lease, how to really asset manage.**

"What the private sector is asking for are great relationships, particularly banking relationships, plus international experience on more than one continent."

New money in the market

Even in the current climate, opportunities exist to profit from commercial property – if the investment can be found. Where is it to come from? Our expert panel explains

When will banks start properly banking again?

"The banks have not been pushing property out very fast. There is some £300 billion of debt made against property, and probably deleveraging that, it's going to be something around 100, 125 or £150 billion. Yet we haven't seen £150 billion of foreclosures coming onto the market. In the process of deleveraging, we'll have a potential of very significant impact around markets over the next five years. My personal feeling is, I think they will take a long time to gradually reduce their debt."
– Philip Clark, European Head of Property Investment, AEGON Asset Management

Are we living in a new paradigm of investment?

"The future generally is about a lower leverage investment profile, which means a lower risk and acceptance of a lower return. That is, I think, the future of the next 10 years of investing in real estate." – Pieter Hendrikse, CEO of ING Real Estate Investment Management Europe

How is the movement of capital changing strategies for investors?

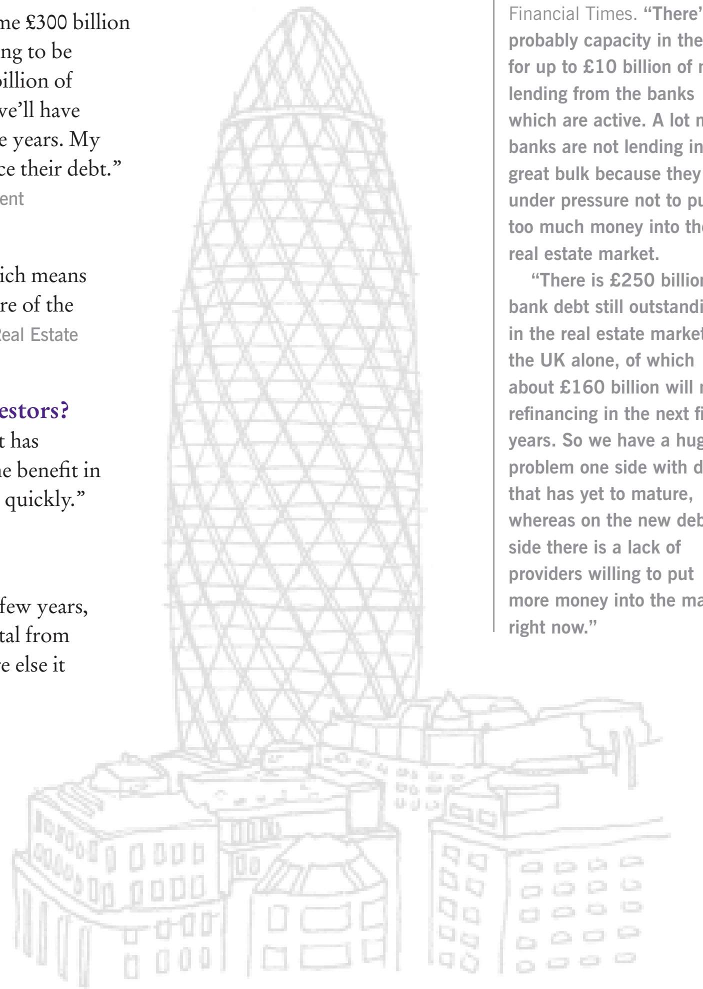
"You can measure the cycles of real estate, and over the past 30 years it has outperformed other investments. The important thing is liquidity… the benefit in Europe, especially in this environment, is that you can make decisions quickly."
– Rogier Quirijns, Head of European Research, Cohen & Steers

Where will new debt come from?

"There's a big fear of CMBS loans all hitting the market over the next few years, all at once. But I think an updated version of CMBS could attract capital from investors. Don't assume it's dead as a form of capital – I can't see where else it will come from." – Philip Clark, European Head of Property Investment, AEGON Asset Management

Are there other sources of investment that don't rely on CMBS?

"There is money coming back over here from Asia. They're making a lot of money over there, and looking for places to put it. I'm optimistic about capital coming in from these new economies that have really vast amounts to invest – and want a secure place like our commercial property markets."
– Nick Scarles, Group Finance Director, Grosvenor Group Limited



Banks must catch up with debt reality

"Right now the property market is starved," says Dan Thomas, Property Correspondent of the Financial Times. **"There's probably capacity in the UK for up to £10 billion of new lending from the banks which are active. A lot more banks are not lending in great bulk because they are under pressure not to put too much money into the real estate market.**

"There is £250 billion of bank debt still outstanding in the real estate market in the UK alone, of which about £160 billion will need refinancing in the next five years. So we have a huge problem one side with debt that has yet to mature, whereas on the new debt side there is a lack of providers willing to put more money into the market right now."

What can be learned from the conference?

Opinions from all sides of the sector appeared to agree on some things – especially the direction in which the market should be driving, despite some pessimism

Whether the market is rebounding or recollapsing, the imperative factor discussed across the panels of the conference was value. In the current climate, only by thinking creatively about location and type of development, as well as new ways of seeking investment, can the market move forward. Squeezing every bit of value from property is as important as it has ever been

While the long-term effects of government controls have yet to be seen, it's certain that in the banking system there is still some reluctance – and in some cases, inability – to lend for real estate. Sovereign wealth is one answer, as is the prospect of a new kind of CMBS that is adapted and updated for today's economic outlook – a point made by the panel of The New Money discussion.

Added to this is the demographic reality that a great swathe of the developed world – except the English-speaking nations – have a declining population. Demographics are an anchor of data in an uncertain world, and we must heed their warnings – as Leanne Lachman of Lachman Associates LLC pointed out at The New World panel: "For the rest of the developed world, it's a pretty sober picture for the next five to 10 years." Giants like China and India, and their economically tied neighbours, are expanding. Despite fears of a bubble in the overdeveloped cities of these nations, there seems to be opportunity if you can source the right location.

Quotes from the conference delegates

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Do you have any concerns over whether the proposed changes to lease accounting will have a negative impact on negotiating leases?
It will have an impact, because people will have to take the liability over the term of the lease. How that actually manifests itself in terms of rental yields has yet to be seen.

Andrew Frieth, Managing Director of Fund Development and Administration, The Managing Group
Should the government do more to help those businesses in the property sector?
We're trying to set up an FSA-regulated fund investment vehicle. When talking to the various advisers, it's clear that the government is trying to dissuade us – leaving people open to exposure and risk.

Julian Lyon, Manager of European Real Estate, General Motors
Are you more conscientious about the risk controls in the event of a double dip?
The problem we've had is that more asset classes have been pressed into one, which has created a bigger system; when the system fails, everything seems to fall.

Kevin Hoy, Head of Real Estate, Mason Hayes & Curran
How much of an impact will the comprehensive spending review have on the current market?
We've had a spending review in Ireland already, and we've seen the impact of that being lower spending and, therefore, lower tax revenue. There's a risk of that contributing towards negative impacts on the wider economy.

Dan Thomas, FT Property Correspondent
Is there going to be a double dip?
In the UK, we're definitely in for a period of slow or sluggish growth, if not negative growth.

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