［第１06回講演録］

Real Estate: Information, Indices and Benchmarks

INVESTMENT PROPERTY DATABANK
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■Introduction

I want, in the next hour, is to talk about the enormous changes in the way that property is owned and managed as an investment that have taken place in the last 20 years in many developed countries. Property as an asset class has moved ever closer to equity and bond markets in the way it operates. The extent of these movements has been evident in the very strong real estate markets that we have seen recently. The movements taking place in the US and Europe are certainly taking place in Japan and demand the same kind of information support as have been developed for other markets. I will talk a little of the types of information that are available about the property market and about property portfolios in other countries and will illustrate some of the uses to which this information is put.

My presentation is very long and I cannot talk about all of it. So I hope that you find some of the slides interesting and will be to look at them outside this meeting. All the slides are supported by wider papers which I can make available to you separately if you want them.

■The UK of the 1980s

I first came into real estate industry in the United Kingdom in the early 80's, having practiced as a professional economist. The United Kingdom has had a Funded Pension Scheme for many years and pension and insurance companies have been investing in real estate from at least the early 1970s. The government encouraged pension funds to buy property after the real estate crisis of 1974. Many investment managers looked to real estate as an inflation hedge in the 1970s when the British economy was in a bad way and increased their allocations. This movement was greatly aided by the "invention" of the long lease back in the 1960s which passed on much of the management headache of property to the occupier; and offered the owner long term security of income.

The market in which institutional investors were placing their funds in the early 1980s was exclusively national. No investment was taking place outside the United Kingdom; and there was no sign of foreign investors trying to buy buildings in Britain. The range of choice of investors was narrow. They mostly bought offices, which accounted for 60% of portfolios; and they invested largely in the City of London and West End London markets. They were buying large blocks of real estate rented to leading companies with secure leases. The market was dominated by the institutions, and the strength of their cash inflows meant that they very rarely used debt. The quoted property companies were finding it difficult to raise finance and they were effectively inactive from the late 1960's until the late 1980's.

Thus, the UK at the time had a very straight-forward market in which institutions were dominant and owned a limited range of secure real estate. IPD assembled information about these assets to produce its first indices ……and these indices proved valuable in helping asset allocation decisions.

■But has changed beyond recognition

Enormous changes have taken place over the last 20 years. Many of the same owners, especially the big insurance companies and pension funds, and long established quoted property companies, are still important in the market. But the market is very much larger: ownership by the financial institutions of property was £35bn in 1985 but is now £150bn. New owners have come into the market in a big way, especially retail investors; there are many funds for wealthy individuals; and many international investors.

Investors own a wider range of assets than previously. Retail property now accounts for more than 50% of all holdings and "new" property types have been absorbed into property portfolios – including retail parks, business parks; leisure properties; hotels and the like. London now accounts for less than 20% of all portfolio investment held by domestic investors.

■Reasons for the change: in Europe

The market has become truly international, and this has been welcomed. The presence of international investors meant that the impact of the '90s property crash on the economy was less in the UK than elsewhere in Europe. The fund management industry which looks after commercial real estate has also changed. In the mid 1980s there were some 400 funds run by some 300 separate property managers. Now there are 20 fund managers who look after more than 75% of all the assets recorded in IPD's London database…..property ownership and property investment management have largely been separated. The investment managers come from a number of backgrounds:

- Equity fund managers have built up specialist real estate departments. These include Henderson and Schroders and Merrill Lynch.
- Property managers who themselves looked after big portfolios for their parent companies have started to provide a similar service to third parties. Thus, the largest fund manager in the UK is the Prudential with some £20 billion under management and many third party accounts. Similarly, Standard Life and AXA have become important property managers.
- And listed property companies have moved towards providing specialist fund management services, offering their expertise and entrepreneurial flare to other "passive" investors….for a fee.

The internal organisation of these new fund managers is modelled on that of an equity manager with designated fund managers responsible for each fund. Each manager follows a strategy with a planned process. Returns are monitored closely with reports going to investors quarterly. They take their reward in part from their success.

There is an increasing trend for pension funds to invest in multi-investor funds, and these are conceived, marketed, and monitored in a regulatory framework and are relatively transparent.

■And the US influence

While the domestic investment markets in Europe were changing they were also heavily influenced by the major US investment banks, who sent teams to Europe in the mid 1990s and took very large positions in the crashed out property markets of France and Italy– from which they made very large profits. These profits were in turn used to justify setting up Opportunity Funds which raised large sums from US pension funds. When the investment banks arrived in London they brought with them other new techniques, particularly with regard to debt and debt securitisation, and further widened the range of financing options available in the property investment market. The investment banks started by being most interested in Europe, but moved much of their focus onto Asia in the late 90s.

■Most European and North American real estate markets are now

Trends pioneered in the UK and US have spread pretty rapidly in the last 10 years. Markets are now much more liquid throughout Europe. There have been big increases in international and cross-border investment. Professional approaches to property fund management have spread widely. Markets are more transparent. And, importantly, they support much higher levels of real estate activity. I will show you slides to illustrate each of these points.

Liquidity is clearly extremely important for investors. Whereas the level of turnover (sales and purchases as a proportion of fund size) has increased in the UK from around 10% to over 20% in the last 15 years; much more dramatic increases have been seen in other European countries.

The scale of international investment has also increased enormously. It is probable that 20% of the London and Paris office markets are now owned by non local investors. The flow of cross-border property investment in Europe has reached around €40 million per annum which is around 40% of all investment. The markets that have been the most important recipients – UK, France, and Sweden – have benefited in terms of reduced yields, increased development activity, and a wider range of available stock. Investment in other markets, which are often perceived as illiquid or poorly informed (most notably Italy and Eastern Europe) has been much less and at rather higher projected rates of return.

However, the most obvious effect of the professionalisation of the market has been the growth of non-listed property vehicles. A sector which was valued at approximately €20 billion in 1996, when there were some 100 co-investment vehicles on offer; has grown to one with nearly €150 billion of investment in some 450 vehicles in 2004. These vehicles offer a wide range of product and risk exposure. Some are effectively joint ventures between large existing real estate investors. At the other end, however, are partnerships which allow smaller pension funds and wealthy individuals to invest in some of the largest shopping centres; specialist areas of the real estate market; and emerging areas of Eastern Europe and Southern Europe.

■Property is Becoming More Liquid

A market which is larger, more diversified, and more liquid has called for much higher levels of transparency. This has been met in a number of different ways.

Two organisations in Europe have established a Europe-wide base to look at quoted and non-listed real estate vehicles – EPRA and INREV. Both organisations are based in Amsterdam and have concentrated their attention on standardised reporting, best practice, and transparent reporting of management costs. They have both created an index of market performance for the investment vehicles that they cover.

Similar types of property indices are available to property investors in both Europe and the US. At a basic level investors want to understand the changes that are taking place in the markets. IPD has developed its databanks of the direct property holdings of all major investors which allows changes in capital values, net incomes, market rents and total returns to be monitored at a national, sector and regional level. Last year IPD produced indices for 14 countries, and provisional statistics for Italy and Japan where our samples are still small. In the US we produce benchmark reports for the major funds, utilising the NCREIF data and working closely with NCREIF.

IPD also provides benchmarks to investors to show how they performed, including their transaction and development activity. These are the portfolio benchmarks which I will talk more about later.

More recently with the emergence of the private funds and indirect vehicles IPD has been monitoring the return on net asset value of these investment funds. And of course listed companies are monitored by stock market indices which also include the new REIT vehicles.

■Japan is not an island!

This is all that I want to say about changes in the European markets that have taken place and in the second part of my speech I would like to switch my attention to Japan.

I think it is evident that enormous changes are taking place in the way that the property market works in this country. First there is the increase in the size of the investment market as many buildings pass out of the ownership of either corporates or banks into the hands of professional investors.

There appears to be a large latent demand for property from both insurance companies and pension funds for the first time for a number of years. Property is being treated as a financial asset in which both the income and the capital value are important. The launch of the JREITs has been successful and has brought retail investors into the market for the first time….and there is strong international interest in investing in Japanese real estate market.

Growing investment market scale; the interest of the institutions; securitisation; and internationalisation; are all trends that are happening also in European and North American markets.

■Japanese information requirements similar to other countries

They all suggest the need for better information…..for the long term savings industry; in order to understand the market better; to provide tools for the financial analysis of real estate…and to make sure that the new found interest in real estate spreads to all parts of the market and the country…..I will talk about each of these factors in turn.

First I think it is obvious that a real estate department of an insurance company or a pension fund needs the same quality of information about property as is available for its equities and bonds. If this information is lacking property will be treated as a high risk asset on which the risk premium is higher. Property will not be the third asset class but will be seen as an 'alternative investment'. Real estate allocations in institutional portfolios have been increasing in recent years and now often exceed 10% in Western Europe.

■Understanding real estate as an investment asset

I think that there are four aspects of market information that are essential for the real estate investor to understand.

The first concerns the nature of the property market cycle- the historical occurrence of cycles and econometric analysis concerning their causes and duration.

I think we can all describe the sequence of a property cycle…from the recovery phase; through the start of an interest in development and the increase in bank lending; to the rapid increase of rents as vacancies become rare but new buildings are not yet available; and then the building boom which lags the demand cycle, overshoots and pushes the market into recession.

This is what the cycle looks like in the UK over the last 30 years…three booms; three large scale recessions. You can see how rental growth is triggered by the upturn of economic activity….how rents tend to lag this upturn…. and the trend of building orders. While the recent trend has been more benign no one believes that the cycle has gone away.

The pattern of returns is rather different between countries, from a low of 6.4% in France over the last 17 years to a high of nearly 15% in Ireland. But the basic relationships seem similar in each country. The economy is the primary driver of the cycle. Returns are only weakly linked to inflation. And property is only weakly linked with other financial markets

■How accurate are valuations?

I will now turn to the topic of valuations…. this is of great importance to real estate investors as there are insufficient transactions to measure capital value performance as would be normal for the stock market. Are valuations accurate?

A great deal of research has been carried out by IPD on this issue in many countries. In broad terms the correlation between transaction price and previous valuation is good…….regression results of .95 and higher are not unusual…… and the range of valuations around the median is relatively narrow

We can see too how this range has tended to narrow over the years…again a result common to many countries and suggesting that investment valuations are improving over time. We have not yet got sufficient data about Japan to undertake this type of analysis but will carry it out possible….and feed the results back to appraisers.

■Understanding property income

Property investment is typically for the long term especially as the transaction costs are so high….in these circumstances the pattern of the income that is received is very important. Is it secure? When is the income flow threatened? What happens if a tenant quits? IPD holds information in confidence about all lease contracts and these can be analysed…the figures are for the United Kingdom. Around one-third of tenants renew their contracts…… and there is an immediate re-letting on many other buildings and this often results in a rent increase. But if the space is not immediately released the vacancy period can be long….averaging 15 months. But the actual loss of income from business failures is very slight indeed.

These statistics allow property owners to understand the pattern of their future cash flows, and the probability of certain outcomes when a lease event occurs…they also give a secure base for valuation assumptions. As you might expect there are very big variations in these figures between property types and different areas of the country.

Property owners also need to understand the pattern of obsolescence on their buildings- how quickly will the ability of the investment to capture market rent continue; how much capital expenditure will be needed on the building. We have undertaken very detailed studies which compare the capital value of new and older

buildings and show how obsolescence affects building value over time.
Offices show much higher rates of obsolescence than retail properties and some of the newer investment categories such as retail warehouses and hotels also suffer rapid depreciation. We have shown how important it is that REITs distribution policies do make adequate provison for depreciation.

■Depreciation and Obsolescence in property portfolios

The information I have discussed above concerns the development of a better under-standing of the real estate market, much of which has been aided by the IPD statistics. Investors also need more sophisticated financial information to help them mange their portfolios

I have produced slides in the pack that cover use of IPD data for asset allocation decisions; for benchmarks; for comparative pricing; and to act as the base of a derivatives market which is just starting to emerge.

You can compare the return on direct property to that of gilts and equities over a long period of time…and track the volatility and risk measure. You can then build a correlation matrix, covering different periods. Property returns have been strong recently, but over the long term they have fallen between the level of returns of equities and those of bonds. They show low correlations with either of the other two asset classes and have useful portfolio diversification characteristics.

■Managers and Investors Need Benchmarks

Managers need benchmarks to help them understand their portfolios, to compare them to the returns of other investors and to present their results to investors……

Benchmarks cover the components of return in the portfolio but also other aspects such as vacancies and management costs. They can start either from the direct assets held in the portfolio and work upwards- through the indirect holdings, the loans, and the management costs…up to the level of the total return of the fund as received by an investor. Or we can work top down from the shareholder return to the level of the asset return.

We have developed many analytic tech-niques to aid this process, which turn on the question of where the returns come from….how has it achieved its returns; were these returns consistent with its stated style; were the returns expected or not. In essence we need to try and understand if the manager was skilled…..or just lucky!

Investment is about choice and internation-al investors want to be able to compare the returns from different markets…most especially the new fund management groups who are establishing global distribution networks and global funds.

We do now have statistics for Japanese returns for the last year. However the sample on which they are based remains very small compared to the size of the market and their returns are only provisional, however, in 2003 market values were continuing to decline only slowly and the income return on the investment market is not dissimilar to that of other leading markets.

■Property derivatives….a long time in coming

Finally the IPD index is now very well established in the European markets. As investors have come to trust it and to understand how it works they have started to develop derivative products on the back of it. A number of attempts have taken place over the last ten years, but a small but quite active market has started to emerge in the last year. Offering the same kind of investor benefits as you would expect from managing an equity portfolio…..a rapid increase or decrease in sector exposure; risk diversification; market hedging…there is a very great interest in these mechanisms which may increase rapidly in future years. The model of the Barclays contract is shown in this slide.

■Project financing for cities and regions

Finally the property investment market is a powerful mechanism which will determine the level of development and investment that will take place in different areas just like a stock market one of its primary functions is to allocate flows of new money. Statistics can help the efficiency of this process, and reduce transaction costs.

I would like to give you two examples of this in action

Returns to property in Northern Ireland over the last twenty years have been constantly superior to those of other regions of the UK despite the sectartian violence of the area….. indeed returns on retail properties have been higher in 19 out of the last 20 years.

We then widened this analysis to take into account the 10% and 20% of poorest (lowest income) areas of the UK…and found the same result: both the rate of rental growth and the absolute level of yield were high in the poorer regions, meaning that investors received a higher return.

Quite simply investors place too much emphasis on the appearance and reputation of an area and do not look carefully enough at the underlying market statistics…you can often make better investment returns in poor areas than in wealthy areas.

Thank you for your attention. We are trying hard to get an IPD system of analysis in place in Japan and have received great help from a group of important investors including Nomura, Meiji-Yasuda, Tokyo Fire and Marine…I believe that we can construct a system that will be as useful as that in the west and we look forward to working with you

Many thanks