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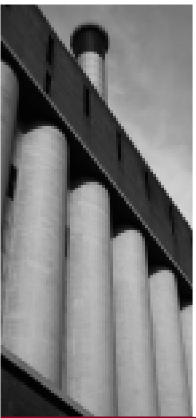
Investment performance and lease structure change in the UK




Research Findings

Summary Report
July 2005

Investment performance and lease structure change in the UK

Executive Summary

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The IPF Educational Trust and IPF Joint Research Programme

This research was commissioned and funded under the auspices of the IPF Educational Trust and IPF Joint Research Programme. The three-year programme supports the IPF's wider goals of enhancing the knowledge, understanding and efficiency of property as an investment class. The initiative provides the UK property investment market with the ability to deliver substantial, objective, and high quality analysis on a structured basis. It will enable the whole industry to engage with the other financial markets, wider business community and government on a range of complementary issues.

The programme is funded by a cross-section of 16 businesses, representing key market participants. The IPF Educational Trust and the IPF gratefully acknowledge the contributing organisations:

Capital & Regional, Donaldsons, Grosvenor, GVA Grimley, Investment Property Databank, KPMG, LaSalle Investment Management, Land Securities, Lovells, Morley Fund Management, Nabarro Nathanson, Prudential Property Investment Managers, Quintain Estates & Development, Scottish Widows Investment Partnership, SJ Berwin and Strutt & Parker.

Investment performance and lease structure change in the UK research team

Neil Turner*, Ian Cullen+, Jeremy Marsh+, Charles Ward#, Patrick McAllister #, and IPD staff in London and Paris

* Alecta Investment Management
\+ Investment Property Databank Ltd
\# The University of Reading Business School

The Project Steering Group

The IPF, appointed a project steering group to guide and assist the Research team. The full group worked on the stage 1 of the project, which comprised the historical analysis in response to the ODPM consultation paper on upward only rent reviews. A smaller group of four (##) oversaw stage 2 the forward-looking analysis and completion of the project. The IPF acknowledges the contribution from: Andy Martin## (Strutt & Parker), Richard Bartholomew (Boots Properties Plc), Michael Brodtman (CBRE), Adrian Elwood (Eurohypo), Mark Titcomb## (Eurohypo), Gerald Kaye (Helical Bar Plc), Michael Lindsay (KPMG), Jonathan Thompson (KPMG), Dion Panambalana (Lovells), Marin Cumberworth (M & G Prudential), Peter Pereira Gray## (The Wellcome Trust), Michael Newens (Vodafone) and Charles Follows## (IPF).

Preface

This report is the executive summary from the full Research Findings which is available as a separate report.

Introduction

The UK has long had a reputation as a market of long leases lengths. However, inexorably this has changed over the last 15 years. The average lease length in 2005 is much shorter than those of the 1990. In May 2004 the Office of the Deputy Prime Minister (ODPM) published a Consultation Document: Commercial Property Leases: options for deterring or outlawing the use of upward only rent review clauses. (UORR). The paper sets out six options:

- No change from present
- Total ban on UORR
- A ban on UORR, with floor to initial rent
- An automatic right to break if the UORR produced a rent above open market levels
- Set a (unspecified) limit to lease lengths making UORR unnecessary
- Compulsory lease price 'menu'.

The IPF had commissioned this research project before the ODPM consultation paper was published. The Research Team, lead by Neil Turner, quickly agreed to amend the project to help the IPF respond to the ODPM consultation. The project timetable was accelerated and stage 1 of the research - the historical analysis - was completed for the IPF. The research team then returned to the project to complete stage 2 the forward-looking analysis and the completion of the entire project.

Objectives

The research investigates the effects of changing lease structures on the investment performance of real estate portfolios. The project was split into a number of clearly defined tasks. First, a thorough overview of the literature on existing research on the pricing of variations in lease terms. Second, basic empirical analysis of property databases examined how variations in lease structures have produced disparities in the level and pattern of income growth and total return. Third, simulation approaches were applied to model the impact and implications of variations in lease structures on real estate performance. The project addressed the effects of changes in leasing practices within the wider context of the role of real estate in the multi-asset portfolio in terms of diversification and risk.

The IPF congratulates the Research Team on an excellent project that lays the foundation for a deeper understanding of how lease structure will impact on the cash flows, returns and risks from investing in commercial property in the UK. The first stage of the research findings, formed an integral part of the IPF response to the ODPM Consultation Document: Commercial Property Leases: options for deterring or outlawing the use of upward only rent review clauses. The forward-looking analysis and complete report will be part of the IPF's ongoing discussions with the ODPM.

The IPF invite comments on the findings and the recommendations for future research. Please address comments or suggestions to Charles Follows, Research Director, IPF 3 Cadogan Gate, London SWIX 0AS. cfollows@ipf.org.uk 020 7695 1649.

1 Executive Summary

This report presents the findings of the IPF Educational Trust sponsored research into modelling the impact on real estate returns of substantial lease regime change in the UK. It also describes the potential impact of this behaviour upon real estate allocations within a multi-asset portfolio.

This modelling has been undertaken in a historical context (1981-2003) and in a future context (2004-2025). The principal aim of the study was to identify the impact on the level and pattern of real estate total returns of introducing a new lease regime imposed by Central Government in the UK.

The key findings of the historical modelling exercise are:

Options two, three and four did not materially impact the pattern of total return delivery at the all property level. Further, the ALM work undertaken suggests that such muted impacts would not have had asset allocation implications for real estate. This was true for the yield adjusted results (where property yields were revised up and down to reflect the anticipated reaction of the capital market) as well as the unadjusted returns.

However, significant impacts were recorded at IPD market segment level. Generally, those segments with volatile rental cycles suffered large income penalties, lower returns and much higher levels of volatility. The Central London office markets were particularly affected.

All mutations of option 5 produced substantial reductions in property returns and mild increases in volatility. These differences were sufficient to materially reduce allocations to real estate in the ALM modelling exercise.

The future modelling exercise has highlighted that:

There are only small differences in return delivery between all of the options at the all property level for the yield unadjusted and yield adjusted results. We believe this is explained by the substantial, market-induced, lease structure reform that has already befallen the property market.

We find that the UK commercial leasing market is now in uncharted territory with regard to lease length. Never before in the modern history of the UK commercial real estate market have lease lengths been reduced to below 7 years at the all property level as they were by year-end 2003 for new leases granted.

Since lease lengths are so much shorter at the beginning of the future modelling work (year-end 2003) the market has removed – to a very large extent – UORR provisions within our modelled cash flows. Their arbitrary removal, therefore, by legislative intervention modelled under the various options is largely superfluous and consequently does not register large impacts on returns.

These results suggest that real estate allocations would be maintained at very high levels under any of the options modelled since the differences between the base case and the various options were marginal in the future series.

In a similar fashion to the historic modelling, the future returns did display larger impacts at the segment level and the yield adjustments reinforced the volatile market segments' vulnerability to short lease contracts with frequent marking to market of income.

Perhaps the most striking feature of the research is the reduction in the efficiency of real estate return delivery between our historic and future modelling results. Historically, risk adjusted (nominal returns/standard deviation) real estate returns have been as high as 1.21. At this level it is significantly ahead of other asset classes. The future modelling work, utilising the latest lease contract information, suggests this metric is no higher than 1. Although still above the other two major asset classes, it has clearly been affected by lease structure change and such deterioration may have series implications for real estate allocations in the future.

Finally, the research team would like to stress that the results, conclusions and potential impacts are conditional upon the assumptions made about market behaviour. The reader should be aware that we do not analyse the behaviour of individual assets or individual investors. Indeed, we assume that any specific risk has been diversified away and that all investors behave as if it has. Clearly, where small, individual investors or other non-diversified funds operate different behaviours to the efficient one we have assumed might prevail. Non-diversified investors operating in volatile market segments or segments where the majority of value of an investment is in the lease contract might exhibit different types of behaviour to those that we have assumed in our modelling exercise.

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