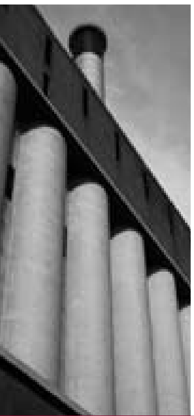
Investment Property Forum

INVESTMENT PROPERTY FORUM Educational Trust

Property Stock Selection: Organisation, Incentives and Information



Research Findings

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This research was commissioned by the IPFET and IPF Joint Research Programme

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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.

The Research Team

Paul Gallimore (Georgia State University, Atlanta), Pat McAllister (University of Reading) and Cathy Hughes (University of Reading)

The Project Steering Group

The IPF appointed a project steering group to guide and assist the Research team. They gratefully acknowledge the contribution from the Chairman – Richard Barkham (Grosvenor) and the members Gerry Blundell (LaSalle Investment Management), Stuart Cowe (SWIP), Peter Hobbs (RREEF), Paul Kennedy (Invesco) and Charles Follows (IPF).

Property Stock Selection: Organisation, Incentives and Information

Introduction

This research studies the selection and use of information in investment decision-making. It is centred on the processes surrounding stock selection decisions about the acquisition and disposal of direct real estate assets.

Commercial property investors constantly make decisions in uncertain situations. At the single asset level, they face decisions about whether to buy or sell an investment, sometimes in competition with other assets. With the implied aim of maximising expected performance, the analysis of the cost and benefits of individual investments dominates the stock selection process. The vast majority of institutional investors use discounted cash flow models to inform buy or sell decisions about individual assets. This approach requires the investment analyst to process information on a range of variables, critical to the estimation of investment value. This research examines the selection and application of these information variables in investment decision-making, centred on the stock selection decision. At its core are the behaviours displayed in risk perception and evaluation, in information selection and processing, together with the associated consequences.

Within an organisation, investment decisions involve a number of principals who together with internal and external professionals have a diverse range of expertise, incentives and influence. Misaligned incentives, poor organisational structures and individual biases may contribute to sub-optimal decision-making and the acquisition of assets that will under-perform.

Using interviews with key participants the research examines the buying procedures and decisions processes of major UK investing institutions. The study builds from insights and methods that treat human decision-making from a behavioural perspective. Investigations from this perspective have shown that decision-makers may exhibit a range of sub-optimal behaviours, compared to the assumptions underpinning orthodox economic and finance theory. Many of the findings relating to such behaviours arise from studies in the field of behavioural finance or investment decision-making. The study augments this perspective by drawing from other key research areas that inform decision-making processes: namely organisational behaviour and agency theory.

The project advances our understanding of how stock selection decisions are made and thereby enables improvements in such decision-making, leading to a more efficient use of investment funds.

The IPF ET and IPF congratulate the research team and invites comments on the findings. Please address comments or suggestions to Charles Follows, Research Director, IPF, New Broad Street House, 35 New Broad Street, London EC2M 1NH.
Email cfollows@ipf.org.uk 020 7194 7925 Switchboard 020 7194 7920. Fax 020 7194 7921

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Executive summary

Although performed routinely, the process of finding, evaluating and acquiring commercial property assets for investment is complex. The lack of central trading, the heterogeneity of assets and markets and the intricate system of information needs that have to be sourced and assessed present a challenge to organisations in the efficiency with which they navigate this process.

The purpose of the study reported here is to contribute to understanding how successfully and efficiently participants in the stock buying process – and the industry itself – organise and manage their relationships to achieve their aims. Specifically, the focus of this research is on the buying procedures and decisions of major UK investing institutions.

The buying process involves a number of functions and it is inevitable in large organisations that responsibility for these functions is shared between individuals. These functions relate to:

- *Search:* identification of appropriate stock;
- *Information collection:* on the characteristics of the assets, the seller and the nature of other potential buyers;
- *Negotiation:* conduct of negotiations, development of pricing and bidding strategy;
- *Evaluation:* in-depth analysis and appraisal of investment opportunity;
- *Implementation:* transaction management and due diligence.

Typically, although a decision is made within a single organisation, it will involve a number of principals and internal and external professionals (agents, researchers, fund managers, asset managers, clients *inter alia*) who have a diverse range of expertise, incentives and influence. A key risk is that misaligned incentives, poor organisational structures and individual biases may contribute to the acquisition of assets that will underperform.

The study described here is centred on semi-structured interviews involving 11 buying organisations, supplemented with subsequent interviews with a small number of introductory agents. The main interviews were conducted in the second half of 2005.[1] Although all the organisations were naturally involved in fund management, the extent and nature of their property portfolios, and the needs of and mandates from their clients, differed considerably. One factor that clearly influenced many organisations' current and recent activities at the time of the interviews was the 'hot' state of the investment market leading up to and during 2005.

The framework for the study combines perspectives drawn from research in the areas of organisational buying behaviour, agency and transaction costs and cognitive psychology (as applied, for instance, in the realm of behavioural finance).

Key findings and conclusions

The study's key findings on the buying process and decision-making relate to:

- Organisational structures, incentives and remuneration
- The role of introductory agents and agency costs
- Information and its management

[1] Interviews were conducted with 19 people in the buying organisations, and three introductory agents. The managing director of the Propex system was also interviewed.

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Organisational structures and remuneration

Trends such as the growth in external mandates in traditional insurance and pension funds, the expansion of private property vehicles and retail funds and the growth of specialist fund management businesses have increased the complexity of the property investment sector. This increased complexity in the range of property investment products and the roles of investing institutions has, in turn, increased the diversity of organisational structures both within and between firms.

There are a number of important similarities in how organisations arrange themselves.

- The organisational basis for most of stock selection can be seen as a ‘buying centre’ i.e. a decision-making unit comprising many players with various roles;
- Team working and joint decision-making are standard, with a broad range of informal consultation and formal approval procedures in place to control operational risks;
- Fund managers play a pivotal role between the buyers and asset managers and more senior managers and principals;
- The remuneration of buyers is not directly linked to acquisitions but, more typically, to the performance of the organisation and the local team involved.

Although there are a number of approaches to allocating fund management, asset management and stock acquisition responsibilities, there is a clear dichotomy between organisations in their use of in-house specialist and non-specialist buyers.

- Organisations who have specialist buyers stress the importance of quick responses, concentration on sourcing stock and market contact and knowledge;
- Organisations who combine the roles of asset management and stock acquisition stress the risk control aspects of buyers managing the assets they purchase. However, they also acknowledge that, in the current market, time spent on asset management is being affected by pressures to acquire stock.

Investment firms show a flexibility and ability to adapt their organisational structures and individual roles in response to circumstances. The weakness of this is that immediate needs prevail and so longer term issues, such as asset management in an ‘all-hands-on-deck’ approach to acquisition in the current scramble for stock, may be neglected. There is no evidence that asset buyers’ incentives are misaligned with organisational objectives. The team-working ethos engendered in organisations is not eroded by remunerations systems, which are generally not focused on rewarding narrow activities at the expense of overall team, or organisational, performance.

Overall, the flexibility shown by organisations in adapting their operating structures and job roles in relation to ongoing change in the market is undoubtedly beneficial. However, the industry needs to be mindful of the danger that prioritisation of work towards acquisition in response to market conditions may be at the expense of asset management opportunities.

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Introductory agents and agency costs

There are typically two intermediaries involved in a property investment transaction. While vendors employ their own selling agents, most organisations use external buying agents in all stages of the acquisition process. Whether buying 'off-market' or by 'best bids', most assets acquired are introduced by external buying agents and it appears to be difficult for potential buyers to source stock outside of this system. Hence it is important for investors to have good relations with agents. For the vast majority of organisations, agents provide advice and information to support the evaluation of the asset as well as transaction management if required.

Buyers recognise that there are incentives for the agent to encourage the investor to offer a 'high' price. This is because:

- Agents are only paid a fee if the asset is acquired;
- The agent's fee is positively linked to the price paid – typically 1% of the acquisition price.

These incentives are counter-balanced, however, by a number of important controls on opportunistic behaviour by agents.

- Buyers are fully aware of these incentives, are well-informed about the market themselves and are in a position to scrutinise information provided by agents accordingly;
- Agents are aware that buyers are aware, and there is a strong counter-incentive in the need to establish personal relationships and trust between themselves and buyers in order to generate repeat and related business and to preserve or generate a good reputation in the market.

The services of external buying agents come at a substantial price. We estimate that the level of fees paid to commercial property investment agents was in excess of £1 billion in 2005.

Intermediaries have an important role to play in the investment market. In particular buyers and sellers recognise the value added by agents who can initiate and broker deals on property that otherwise would not have come to the market. They also value the advice that agents give them in appraising potential assets. However, where assets are widely marketed, the contribution to efficiency of the sourcing role of the introductory agent is less clear. It could be questioned why vendors' agents do not more often approach buyers directly. The answer may be that the process of linking vendors with true prospective buyers would be performed less efficiently than through the intermediary filter of the introductory agent. This is naturally the view strongly espoused by agents themselves. The filter, however, appears to have limited impact, since buyers indicate that a large number of prospective purchases are rejected at the initial stage.

Although this study has not probed this area in depth, the dominance of agent networks as channels of information raises questions of transparency. This, allied to the presence of two intermediaries, casts doubt on whether the needs of the investors are being best served by such a system.

The industry should reflect upon the role of introductory agents in relation to their contribution to efficiency in the market. The conclusions may be that the role is valuable and likely to grow in importance as a bespoke service cutting through the welter of data generated by advances in information and communications technology. Alternatively, the conclusion may be to the contrary, with these advances supplanting the need for aspects of the role. Either way, the likely eventual unbundling of agents' services could become a key influence in future developments.

Information and decisions

The vast majority of stock offered to investors is rapidly rejected in what may be seen as the part of the process that most overtly involves subjective judgements. Decisions are made on a number of bases:

- Failure to meet specific, factual requirements such as lot size, yield, lease terms;
- Knowledge drawn from analyses of previous opportunities in similar locations and/or sectors.

Where assets are taken forward to a detailed cash flow projection, the information inputs are generated by a range of principals and professionals. This task involves forecasting future cash flows (incomes and expenditures) of the asset and pulls in a number of 'secondary' forecasts of future market and building performance adding further complexity and uncertainty to the process. These inputs are adapted, mediated and scrutinised by buyers and fund managers and, in turn, further scrutinised by an investment committee and senior management.

There is some concern relating to information inputs in a number of (admittedly difficult) areas:

- Notwithstanding the IPF research into depreciation, some respondents felt that depreciation was still not being adequately incorporated into cash flows;
- There was notable variation in how target rates of return were adjusted to reflect differences in risk perceptions.

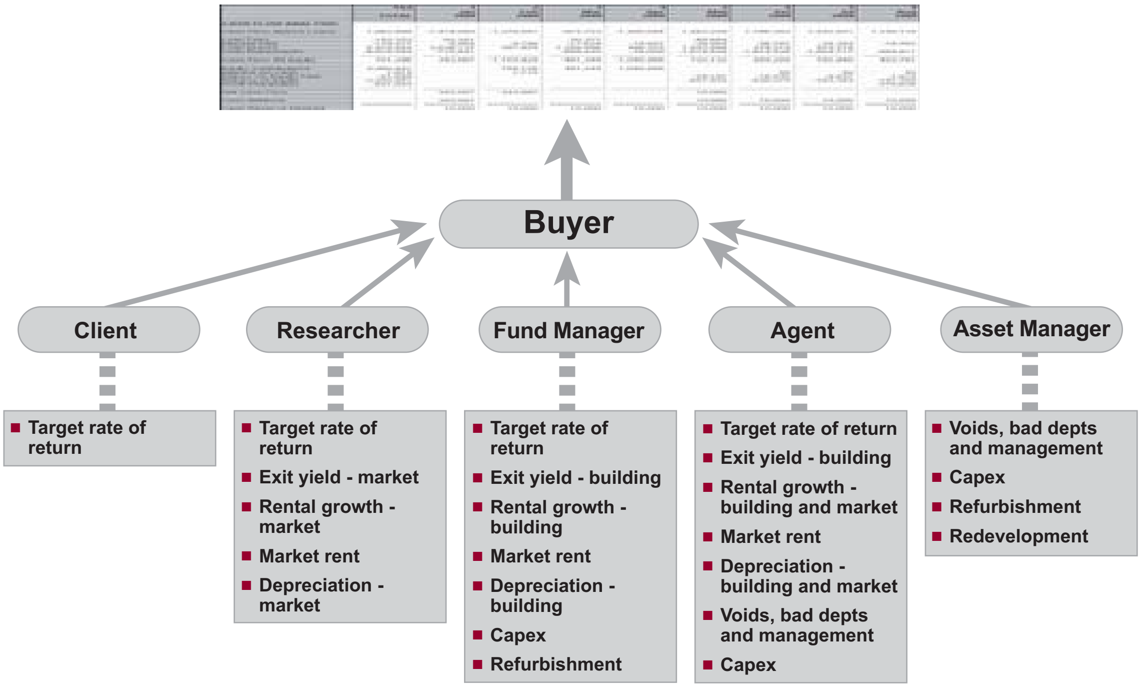
The key non-factual inputs and their providers are identified in Figure 1 (page 12). Typically, research and strategy personnel will generate projections of market trends and the buyer and fund manager will adapt these data at the building level.

While there is considerable scope and, indeed, a requirement for subjective adjustment in applying these variables, it is difficult to see how any buyer or other individual could consistently bias decisions away from organisational policy given the collaborative nature of the process and the controls normally in place. However, the strong influence of market circumstances on behaviour is clear and there is a danger that it creates pressures towards sub-optimal[2] decisions both at an individual and an organisational level.

Organisations should therefore consider the extent to which their risk management procedures, which clearly limit the potential for individual bias, recognise the risk of sub-optimal decisions at the organisational level, when confronted with intense market competition. They should also consider the extent to which certain information, notably risk-adjustment of discount rates and depreciation, influences the evaluation process and might be made more explicit.

[2] Sub-optimal in this context means decisions that fail to fully reflect and balance both short-term and longer term objectives.

Figure 1: **Schematic of the information flows in the buying process**



1. Introduction

The intention of this research project is to examine and analyse the way in which information variables are selected and applied in making stock selection decisions about the acquisition and disposal of direct real estate assets. It involves examining the behaviours displayed in risk perception and evaluation, and in information selection and processing. While people in the property investment community understand what should happen in the stock selection process, prior to this research no-one had investigated what actually happens. This distinction is between – in the jargon – the normative ('should happen') and the descriptive ('does happen') models of human judgment and decision-making; models that have become the stimulus for a fruitful body of research in both financial markets and, to a more limited degree, property markets.

This research approach is loosely termed 'behavioural'. As used in the design of the project proposal, the term behavioural was largely limited to the application of ideas developed from theories in cognitive psychology. In the event, the implementation of the proposal drew from a much wider interpretation of the term behavioural: one which the researchers believe more usefully informs this investigation. This interpretation encompasses important additional perspectives that appear highly relevant to understanding the stock-selection process: namely those from the literature on organisational buying behaviour and the literature on agency and transaction costs. Taken together, these perspectives provide a more comprehensive foundation for the design and analysis of the research investigation and bring together ideas about people's actual behaviour as individuals, agents and decision-takers within organisations.

What immediately follows is an extended review of the literature surrounding these perspectives. Where there are linkages to the stock selection situation this is referred to, although a fuller articulation of these is developed later in the report.

2. The organisational buying perspective

Stock selection decision-making is obviously situated within an organisational setting. As such, the organisational buying literature contains many ideas that link with this buying-decision process.

The study of the organisational buying process is founded on three conceptual models from the 1960s and 1970s (Robinson, Faris and Wind, 1967; Webster and Wind, 1972; and Sheth, 1973). These were developed within the industrial marketing context with the aim of providing marketing and market research people with better ways of explaining and predicting supplier and brand choice. These models were descriptive and general but nevertheless contribute to our understanding of purchase processes. They specified variables that could affect purchase decisions and introduced now familiar ideas, such as the Buying Centre and the behavioural aspects of decision-making. These models were influential, not least because they provided the impetus for the organisational buying research that followed, particularly on understanding decision-making processes and mediating and moderating contextual variables.

To a large extent the focus of research has since shifted towards a relationship-centred philosophy (rather than focusing on the transaction), as organisational buying and selling are now seen as inseparable. This led to the emergence of bodies of research in such areas as buyer-seller relationships and supply chain partnering.

However, in the context of the property investment decision, the focus on the transaction and on the buyer remains appropriate as this decision is not contingent upon the qualities of a supplier but is centred more on the qualities of the product. This is in contrast with the supply of goods and services that are the focus of the organisational buying literature, where the characteristics of the supplier are significant and the relationship between the two parties may be long term.

The three models at the heart of the study of organisational buyer behaviour are briefly described below.

2.1 Main models

Based on observation and interviews, Robinson et al (1967) developed a taxonomy of buying decisions based on three dimensions: the information needs, the degree of consideration of alternatives and the newness of the task to the buyer. The resulting grid (RFW decision grid) is illustrated in Figure 2.

Figure 2: Buying decision grid

Type of buying situation	Newness of the problem	Information requirements	Consideration of new alternatives
New task	High	Maximum	Important
Modified rebuy	Medium	Moderate	Limited
Straight rebuy	Low	Minimal	None

from Robinson, Faris and Wind (1967), Table 4, Page 25

Where all three dimensions are rated as 'high' this is described as a new task. This is seen as a high-risk situation in which many alternatives are sought; the search benefits are considered high in relation to the search costs. At the opposite extreme is what is termed a straight rebuy i.e. a routine purchase situation where all the dimensions are rated as low, consequently information requirements are low and no alternative suppliers are considered. In the middle is a modified rebuy, which may be a new task that has become familiar or a straight rebuy that has changed in nature, where some information is needed and some alternatives may be sought.

The focus of subsequent work by Webster and Wind (1972) and by Sheth (1973) was on description, definition and categorisation of the buying process. Webster and Wind saw the buying task as a five stage process: identification of need, specification, finding alternatives, evaluation and selection. This process is undertaken by a buying centre, a concept which describes the formation of a decision making unit for a particular purchase. The individuals within the buying centre have roles of:

- Users, who use the purchased products or services;
- Buyers, who have the formal authority to contract with suppliers and arrange purchase terms;
- Influencers on the buying decision, who provide information and criteria for evaluating alternative buying actions;
- Deciders, who choose among alternative buying actions;
- Gatekeepers, who have the power to prevent sellers or information from reaching members of the buying centre.

Further buying roles within the buying centre have been suggested by other researchers, such as 'initiator' (Bonoma 1982) and 'spectator' (Wilson 1998).

Webster and Wind (1972) identified four classes of variables that influence organisational buying behaviour:

1. **Environmental.** These are, for example, the economic, political and technological influences that set the scene for buying and also influence the flow of information into the organisation.

2. **Organisational.** This includes the nature of the buying task possibly involving different people at each stage; the organisational structure and its subsystems of communication, authority, status, rewards and workflow; buying technology and the people involved.

3. **Social.** A key part of understanding a buying decision is seen as the identification of the various roles in the buying centre as well as determining the variables relating to the interpersonal interaction between them and outsiders, and the functioning of the group.

4. **Individual.** All organisational buying behaviour is ultimately the result of individual behaviour. Therefore, the task and non-task motives of the individual are seen as important. The former relates to the specific buying problem to be solved whereas non-task motives, such as the desire for promotion, are seen to have the potential to influence performance. Achievement motives and risk-reducing motives are considered important, following on from Cyert and March (1963) who said that uncertainty avoidance is the key motivator of organisational actors. The individual's perception of risk in a decision situation is described as being a function of uncertainty about available alternatives, outcomes associated with various alternatives and how other people will react to various outcomes.

2. The organisational buying perspective

Sheth (1973) created a generic model of industrial buyer behaviour with three aspects:

1. The psychological world of the individuals. Individuals from different departments are usually involved in buying and they have differing expectations of whether the supplier/brand will satisfy explicit and implicit objectives. These are a result of the individual's background, information sources, active search, perceptual distortion and satisfaction with previous purchases.

2. Conditions which precipitate joint (rather than individual) decisions.

Whether a decision is to be joint or autonomous depends upon:

- Product specific factors. The first of these is perceived risk. This is a result of the magnitude of adverse consequences felt by a decision-maker on making a wrong choice and the uncertainty of the buying situation: the greater the uncertainty, the higher the perceived risk. The other factors are the type of purchase (routine or not) and time pressures.
- Company specific factors. Company orientation will indicate who in the organisation will dominate. A decision is more likely to be a joint one in a large organisation than in a small one. The more centralised the company, the less likely the decision will be joint.

3. The process of joint decision making including the decision to buy, gathering of information, evaluating alternative suppliers and the resolution of conflict between individuals.

The main thrust of Sheth's model is to investigate and describe the process of joint decision-making. The most important aspect is said to relate to information – the assimilation of it, deliberations on it and the resolution of the consequential conflict that usually ensues.

2.2 Application and development of the main models

These models, and indeed much of the work on organisational buyer behaviour that followed, assume rational and systematic decision-making and therefore attempt to produce normative ('what should happen') models. However, they do recognise various influences on the buyer and *ad hoc* situational factors, that are not necessarily rational, but will affect the decision. The general assumption of rationality and compartmentalisation of the process has been criticised by many (such as Wilson, 2000) who say that buying is not necessarily like that, although such careful analysis and discussion may be a feature of major capital purchases. Given the nature of the transactions examined in the study reported here, in terms of purchase value and strategic importance, this criticism does not therefore detract from the explanatory potential of these models in the property investment situation.

The RFW decision grid distinguishes new and repeat purchases although the latter is never truly found in property investment – while an investor may be making 'repeat purchases', these are not routine identical items. It may be, however, if properties being bought all share similar characteristics e.g. City Offices, that the information requirements differ from the situation where a purchase is made in a new location; hence a distinction along new task/modified rebuy lines may be found. Similarly, in unfamiliar territory, buyers may feel that the risks of the situation compel them to seek out and consider a number of alternatives, in so far as they exist. There are, however, obvious flaws in the RFW classifications when applied to a study of property investment buying. For example, although an acquisition by a property investor may not be seen as new as in the RFW decision grid, the value and importance of the purchase may be such that the information requirement is always high. Work by Anderson, Chu and Weitz (1987) confirms the findings of

Robinson *et al* that the novelty of the purchase and information needs are related. Anderson *et al*, however, found that the RFW decision grid did not allow for the importance of the purchase or the complexity of the evaluation task (such as in the first time purchase of light bulbs compared with the replacement of fleet cars), and so overstated newness as a factor in purchase tasks. They also highlighted the importance of personal and organisational characteristics in determining when new alternatives will be seriously considered; the original RFW decision grid did not take account of other factors apart from task characteristics.

Modeling buying activities

Bunn (1993) further developed Robinson's approach after observing that, while the original models of buyer behaviour specified variables that affect purchase decisions, they did not address the buying activities that are actually performed. They concentrated on inputs and outputs rather than the decision process itself. Bunn developed a taxonomy of buying decision approaches based on four constructs that underlie all buying activities – procedural control; proactive focusing; use of analysis techniques and search for information. The use of a particular buying decision approach is related to four key situational characteristics – purchase importance, purchase task uncertainty, extensiveness of choice and perceived buyer power. While again the industrial context means that Bunn's findings do not exactly transfer into the property investment context, this more developed decision grid begins to resonate with the investment process, as it suggests that as more complexity and uncertainty surrounds the purchase it will lead to more strategic, long term objectives being considered. In this situation more effort is put into finding information and the use of analytical techniques become crucial.

The stock selection process involves many different individuals in different roles and represents a buying centre as described by Webster and Wind (1972). For example, the fund manager might be seen as the decider and members of an acquisition team as gatekeepers. The composition and roles will vary between organisations and possibly between purchases in an organisation (a fluidity emphasised in Webster and Wind's model).

Applying this model entails consideration, in the property investment context, of all of its four levels of variables, from the individual through to environmental variables such as the market and the technology used by investors to learn about properties. The suggestion may be made, particularly from an agency perspective, that those involved in stock selection are motivated to buy because of individual motives such as the desire to succeed, particularly if this produces a positive reaction from managers (perhaps in a and tangible way such as bonuses). Anderson and Chambers (1985) develop the idea that the behaviour of participants is determined largely by the way in which their activities are measured and rewarded. They suggest that organisational buyer behaviour is best understood using a motivational model of the buying process, in which the reward and measurement system is a fundamental and pervasive influence on behaviour of buying process participants. Therefore, the attributes required of purchasing process participants are learned over time through the measurement and reward system.

In an investment decision, the participants will exert differing amounts of influence over events. Determining the influence of members of the buying centre is a theme of several studies. Kohli (1989) suggested that expert power, the extent to which an individual is perceived as being knowledgeable about relevant issues, is the most important determinant and this is followed by the power to reward and punish (reinforcement power). McQuiston (1989) suggested that the situational attributes of novelty, complexity and importance determine participation and influence in decisions, although a cautionary note was sounded by Silk and Kalwani (1982) who found a lack of agreement about purchase influence between people within the same organisation.

2.3 Information

Information is at the centre of the property investment decision process. The search for information was recognised as central to the organisational buying decision from the development of the earliest models. Research into the use of information in organisational buying has, again, been done chiefly within the industrial context.

Information sources have largely been divided up along two dimensions:

1. Personal/non-personal – i.e. face to face or not
2. Commercial/non-commercial – whether the organisation providing the information benefits financially or not as a result of a favourable buying decision

Much of the research in this area is somewhat disjointed as researchers have typically concentrated on specific types of influence or considered how particular variables explain the buyer's use of information. Early research emphasised the importance of personal *commercial sources;* in particular the pervasiveness of the industrial salesperson throughout the procurement decision process. While the agent introducing an investment to the property investor is acting on behalf of the buyer rather than the vendor, there may be some similarity to the role of salesperson that affects the use of this information source: the agent usually benefits if (and only if) the transaction is concluded. Concerns over the buyer's awareness of the bias of sources such as salespeople have been studied by Webster (1968) and others, who say that buyers do understand and acknowledge that such information content is potentially biased. Work by Baker and Parkinson (1977), Martilla (1971) and Dempsey (1978) suggested that the influence of sales people may in fact be short term. They found that, as the procurement decision progresses, there is a pronounced increase in the buyer's dependence on information furnished by personal *non-commercial* information sources.

Non-personal *commercial* resources also have their place. Morrill (1970) and Patti (1979) found that, in the industrial context, the advertising material of manufacturers is important and can make a positive impression on buyers. Ozanne and Churchill (1971) and Dempsey (1978) suggest that buyers rely on these sources particularly at the beginning of the buying process. Dempsey went on to suggest that, later on in the process of supplier selection, the emphasis shifts to internally generated information sources that are both non-personal and *non-commercial.*

In contrast to much of the research, Moriarty and Spekman (1984) took a more holistic approach. They attempted to produce a comprehensive list of sources used by buyers and to explain their use by reference to the range of predictive variables highlighted in the previous studies. Their research showed that, of the seven most highly ranked information sources, six were personal. Of these six, one was the vendor's salesperson but the other five were non-commercial sources. However, all four categories of information (as set out above) were found to be used throughout the decision process, and the use of all categories was found to be positively related to the amount of decision turbulence or conflict associated with the purchase.

Personal sources (both commercial and non-commercial) were also seen to be relied on more heavily when the purchase is felt to contain elements of both performance and economic risk for the purchasing unit. Overall Moriarty and Spekman found that an understanding of the organisation, and the actors within it, was necessary to explain information use, not least because the various members of the buying centre rely on different sources, as do the more senior staff (relying more on non-personal, non-commercial sources). Also the specific information sources within any particular category that a buyer uses may change during the buying process.

Although the various studies have some differences in findings, many of them suggest that different sources of information will be used at different points in the process and perhaps by different people within the buying organisation.

There have been no studies of this in the property investment context, but the findings elsewhere may suggest that, for example, the advice of the agent is used more at the beginning of the process or by certain people, while in-house research and analysis becomes more important later in the investment decision and is used more by senior personnel.

The complexity of a decision to invest in property may distinguish it from less complex decision situations in terms of the information used. Bunn and Clopton (1993) found that patterns of information sources did indeed vary with purchase decision complexity. Following on from this, Brossard (1998) focused on the information sources used in complex decisions, which he likened to the new-buy situation of Robinson *et al.* He defined the situation as one characterised by a high level of perceived risk, high importance and infrequent occurrence. Specifically, he looked at a decision to invest abroad and asked survey respondents to rank sources used in terms of importance. Personal sources in general were found to be significantly more important than non-personal, with personal sources that were internal to the organisation being particularly relied upon. The outside consultant was found to be an important non-commercial personal source, having the role of expert and providing knowledge and neutral judgment. This result differs from other research on less complex buying processes – such as Moriarty and Spekman (1984). All impersonal sources were ranked least important: again this differs from some previous work. Brossard suggests that this is specifically because of the complexity of the decision process being studied.

The implication of this work for the property investment context may be that personal sources in general, and in particular external non-commercial advisors with no financial interest in the outcome, are much more significant than non-personal ones in the property investment decision. This conjecture is supported by the findings of Gallimore and Gray (2002), who investigated the use of private and public information sources in relation to how property investors gauged investor sentiment. They found that, for this purpose, private information – especially from personal networks – is favoured over other information sources.

2.4 Risk

The work on the use of information emphasises the importance of information search to reduce risk. However, Mitchell (1998) criticises the fact that most studies focus only on information search as the major risk reducer and particularly on the information sought rather than how it is used.

Risk is recognised and included in the original models of organisational purchasing. Both Sheth (1973) and Webster and Wind (1972) emphasise the importance of decision participants' perception of risk on the decision process. Robinson et al's typology is based on the amount of risk perceived in the buying situation; one of their three dimensions relates this to the extent of the information search.

2. The organisational buying perspective

In the consumer field, Jacoby and Kaplan (1972) and Roselius (1971) identified six types of losses that a purchaser can suffer: financial, performance, physical, social, psychological and time. These loss types have not, however, been investigated in the organisational buying context to any great extent. The perceived risks may be broken down into specific concerns about particular aspects of the purchasing decision. Valla (1982) identified five such aspects that could evoke risk – technical, financial, delivery, service and risk related to supplier/customer long term relationships. Clearly the organisation itself can suffer losses, but so can the individual (Newall 1977; Hawes and Barnhouse 1987). Newall (1977) found that the amount of information sought is directly related to the perceived level of buyer and company risk. He found this to be true for both large and small companies.

As Mitchell (1995) notes, the risk of any particular kind of loss is a combination of the probability of that loss and the significance of that loss to the individual or organisation. He identifies 14 possible risk reducing strategies, several of which relate to the specific context of the choice of supply of goods and services. The others include information gathering, group decision making, deliberation, highly structured purchasing procedures, quantitative analysis and user participation.

Some or all of these risk reduction strategies may be in use for property investment decisions. Information gathering and quantitative analysis are those that are the most obvious, although others may be in use and different strategies may be used for different types of risk.

3. The transaction and agency costs perspective

In this section, we focus on the inter-related concepts of agency and transaction costs. Transaction costs are used in the broad sense to include all resources that are used in order to reach agreement for exchange between parties. We provide details of range of transaction costs in the commercial property acquisition process below. We use the term 'agency costs' in two senses. Firstly, in a commercial property context, it is conventionally understood as the fees that agents receive in the disposal and acquisition process. However, it is also used in a second, more theoretical context, to refer to the costs that principals have to incur in order to ensure that their agents (in the wider sense of someone who is authorised to act on behalf of another) make decisions that are in the principal's interests.

3.1 Transaction costs

Minimising the costs of transacting is the central issue in transaction costs economics, a concept originated by Coase (1937) and developed by Williamson (1975, 1985) and others. In a broad sense, Downes and Mui (1998) categorise generic transaction costs as:

- *Search costs* associated with buyers and sellers finding each other;
- *Information costs* associated with buyers learning about the products and services of sellers;
- *Bargaining costs* associated with setting the terms of a sale or contract;
- *Decision costs* associated with evaluating the terms of the seller and internal processes such as purchasing approval;
- *Policing costs* associated with buyers and sellers ensuring that the goods or services and the terms under which the sale was agreed are implemented;
- *Enforcement costs* associated with buyers and sellers ensuring that unsatisfied terms are remedied.

It can be helpful to imagine a market with no transaction costs in which information is freely available, contracts allow for all eventualities, monitoring is not necessary and decisions are always optimal. The commercial property market is far from this ideal.

More specifically, transaction costs can be identified in a typical commercial property transaction. They are incurred both internally by the buyer and externally through the use of intermediaries i.e. buyers' agents. Typically, agents' fees are 'bundled', with a single fee being charged contingent upon successful acquisition[3]. A buyer's agent may provide up to five main services related to:

- *Search:* identification and 'introduction' of appropriate stock;
- *Information:* on the characteristics of the assets and of the seller; the nature of competitors;
- *Negotiation:* conduct of negotiations, advice of pricing and bidding strategy;
- *Evaluation:* provision of information to support investment analysis, financial analysis of investment opportunity;
- *Implementation:* transaction management support, assistance with due diligence process.

Search costs and information are manifestly central to the stock selection process. In a market characterised by complex, private and relatively infrequent transactions, a heterogeneous product and high information and transaction costs; intermediaries may play a crucial role in reducing the length of search

[3] In some cases, there is an element of unbundling. Buyers may pay a fee for the search component but may use an agent whom they consider more appropriate for evaluation.

and increasing the intensity of search. In particular, intermediaries may have advantages in terms of economies of scale in information collection. Elder, Zumpano and Baryla (1999), focusing on the residential property market, conclude that for buyers with high opportunity costs, limited market access and short decision horizons, employing a broker can be utility enhancing due to an increase in search intensity. In the US, the last decade has seen substantial growth in the use of buyers' brokers in the residential market. In another study, Elder, Zumpano and Baryla (2000) found that the use of a buyer's broker reduces search costs but had no effect on price[4].

This line of research in property markets essentially uses a 'transaction costs economics' approach applied to the analysis of asset acquisition and disposal. However, an alternative framework that may be useful for the analysis of the property market focuses on the resources embedded in the relationships between the various actors, stressing the importance of social capital (see, in particular, Sawyer et al, 2003). The key point about this framework is that transactions are not seen in isolation. Rather, they are set within the social structures that the intermediaries help to develop and maintain. It emphasises the value of social networks to solve common problems and the benefits derived from the trust, reciprocity, information and co-operation associated with social networks. Essentially, the focus is on interpersonal skills, shared norms and relationships within a market, enabling access to information that can improve the efficiency of transactions but cannot be divorced from the social structure. However, the ability to improve efficiency is contingent upon the nature of the transaction. Social capital is potentially more important in markets where transactions have a high degree of specificity, long duration, a high level of complexity and information asymmetry – arguably all characteristics of the commercial property market.

Developments in information and communications technology have led to predictions that intermediaries in various markets will become redundant through a process of disintermediation as buyers and sellers find each other through, for example, use of the Internet. This prediction largely comes from writers (e.g. Bakos, 1998) using a transaction cost perspective. In the UK commercial property market where there is typically a buyer's agent as well as one representing the seller, this raises a question for the current study on the value and necessity of these agents. Indeed, the structure of the property agency industry raises a number of interesting questions on the role of the intermediaries and the efficiency of existing market practices for the parties involved, including the importance of social networks to the information flows.

3.2 Agency costs

There are a whole range of professionals involved in the stock selection process – fund managers, researchers, asset managers, agents and acquisition specialists. Individuals influencing the stock selection decision will be prone to different pressures and have a range of motivations which *may*, in turn, bias their actions and advice, both consciously and subconsciously. For instance, in the context of this research:

- Buyers' agents *may* be primarily motivated to generate fee income from transactions rather than ensure optimal asset selection by their clients;
- Individuals who manage the buying process for their investment organisation *may* be incentivised to acquire quantity of stock rather than quality;

[4] Black and Nourse (1995) did not examine search costs but found that for higher priced houses only, buyer brokers managed to generate lower closings costs.

3. The transaction and agency costs perspective

- Fund managers *may* acquire assets in order to increase the size of the portfolio under management and, consequently, increase the size of their fee income;
- Fund managers have to decide how to allocate good quality assets offered to them among different clients and *may* allocate assets to maximise benefits to themselves or their organisation rather than to their clients.

In reality, however, individuals are also subject to a range of countervailing motivations – for example the preservation of reputation and maintaining long-term commercial relationships – which may act to create a complex blend of incentives. Indeed, motivations and behaviour are unlikely to be driven solely by purely economic factors. They may also be influenced by an assortment of social contextual factors and individual preferences.

Incentives are at the heart of agency theory. In standard agency theory, individuals are analysed in terms of whether they are either a principal (person or organisation that authorises an agent to act on their behalf) or an agent (person or organisation authorised to act on behalf of the principal). Agency problems are found where one individual or organisation acts on behalf of another in undertaking some cooperative activity where there is opportunity for moral hazard[5]. It is based on the premise that, where there is goal conflict, rational persons always prefer the alternative that makes them better off. Hence

> *'Agency theory postulates that because people are, in the end, self interested, they will have conflicts of interest over at least some issues any time they attempt to engage in co-operative endeavours' (Jensen, 1994, p.6)*

Ideally, the principal is seeking the perfect agent who will always make decisions without regard to their own interests or preferences. Applied research has tended to be concerned with developing incentive structures that optimise the actions of the agent from the principal's perspective. Studies from the economics of organisations concentrate on the design of incentive schemes to align the interests of the organisation's stakeholders and to promote the organisation's goals. However, a common criticism of standard agency theory is that it fails to see complexity of individual's roles with organisations. For instance, within property investing organisations, both fund managers and acquisition professionals act as *both* principals and agents dealing with a range of information providers and advisors.

The typical agency model is concerned with the optimal contract that a principal will choose to maximise an agent's efforts (MacLeod, 2003). For instance, Eisenhardt (1989) analyses the factors determining whether principals will attempt to link agents' rewards to outcomes or to behaviour. An outcome-based reward structure may be appropriate where transparency and measurability are high and where tasks are complex. Outcome-based contracts tend to reduce agency costs, since they are more likely to align the interests of agents with those of the principal because the rewards for both depend on the same actions. Conversely, researchers recognise that, in reality, there is rarely a clear dichotomy and that, in practice, both behaviour and outcome-based systems are often blended together (Eisenhardt, 1989, Sharma, 1997).

Central to agency theory is information asymmetry. A key problem is that the principal is unable to observe fully the actions of the agent. Consequently, 'if the agent's objectives differ from those of the principal, then the former may take advantage of the unobservability of actions to pursue his or her own ends'

[5] A moral hazard is a situation in which one of the parties to an agreement has an incentive, after the agreement is made, to act in a manner that brings additional benefits to himself or herself at the expense of the other party.

(Molho, 1997, p191). However, the extent of information asymmetry will be variable in different contexts. When the principal has more information to verify agent behaviour, the agent is much more likely to behave in the interests of the principal (Eisenhardt, 1989). Sharma (1997) recognises that in the production of many intangible service products, principals are not passive. In professional principal-professional agent transactions, the principal can have a high degree of involvement in production: co-production is the norm. Additionally, where there are repeated transactions, the principal will become better informed about agents' abilities and characters. For instance, in wholesale financial markets involving professional transaction counterparties and sophisticated institutional investors, Walter (2003) argues that the asymmetric information and competitive conditions necessary for conflicts of interest to be exploited are of relatively limited importance.

The importance of being impartial

The huge press coverage of the scandals involving equity analysts of US investment banks, following financial problems at the Enron, WorldCom and others, was also associated with a large body of academic research on bias in equity analysts' advice. For instance, in the late 1990s, much-cited papers by Lin and McNichols (1998) and Michaely and Womack (1999) provided evidence of distortions in analysts' recommendations; particularly if the analyst's investment bank had a relationship with that firm. In a related piece of research, Malmendier and Shantikumar (2005) attempted to assess whether there were misaligned incentives when dealing with uninformed or small investors compared to informed or institutional investors. They found that analysts affiliated to an investment bank made a strategic choice to distort recommendations to small investors but not the earnings forecasts used by the institutional investors. Analysts may have felt that the incentives to maintain favourable relationships with existing or potential corporate clients were outweighed by the disincentives of loss of credibility and reputation which could occur with 'expert' investors.

Sharma (1997) also emphasises the ability of expert oversight to reduce agency costs. He argues that the professional agent is less likely to behave opportunistically when the principal has access to the relevant knowledge base – in addition to being involved in co-production. The latter can be important since the joint enterprise creates a social bond between the principal and agent and as a result issues such as social influence, interpersonal attraction and trust become vital (Sharma, 1997). The possibility of long term business and social relationships can also be a restraint upon opportunistic behaviour by the agent.

MacLeod (2003) discusses the differences in incentives where there are repeated relationships and there is a threat of separation. In effect, the threat of separation makes the contract self-enforcing and separation itself can produce a loss to both parties. Essentially good advice improves the prospects of repeated custom and leads to reputation benefits. Following Axelrod's (1984) analogy, the 'shadow of the future' may prevail over current incentives. In repeated relationships, Sharma (1997, p778) notes that

> *'…unless an agent does not intend to remain in business beyond one transaction or unless the principal has a short memory or is of a forgiving kind, concern about reputation and potential for future business inhibits opportunistic behaviour.'*

3. The transaction and agency costs perspective

In the accountancy literature, given the enormous weight given to accounting information in capital market decisions, the independence and impartiality of the auditing process has generated a longstanding body of commentary and empirical research. A persistent theme in auditing research is the presence and potential of incentives in the auditor-client relationship to bias reporting. A common concern is auditor independence. This is defined as the absence of collusion between the auditor and the manager of the client firm[6] (Lee and Zhaoyang, 1998). The central concern has been that there has emerged a 'mutuality of interests' between auditor and client, due mainly to auditor economic dependence and/or the provision of non-auditing services by the auditing firm (see Zhang, 1999; Windsor and Ashkansay, 1995; Zimbelman and Waller, 1999). However, more recent work argues that conflicts of interest should not be analysed in isolation from the range of social, organisational and behavioural factors affecting professional behaviour in an auditing context (Almer, Higgs and Hooks, 2005).

In the property literature, the majority of research on principal/agent problems is found in the US journals. Topics relate to managerial incentives in the REIT sector (Solt and Miller, 1985; Hamill, 1993), the role of principal-agent conflict in the Savings and Loan crisis (Eisenbeis et al, 1996), and brokerage incentives (Zorn and Larsen, 1986; Yavas and Colwell, 1999). From the perspective of the research described here, a relevant analysis is provided by Graff and Webb (1997). Contrary to the expectations of the efficient market hypothesis, they identified significant serial persistence in the returns of individual properties. In basic terms, they found that some properties consistently remain in the best performing quartile while others remain in the worst. They explained this persistence in terms of agency costs. They argued that this persistence reflected mis-pricing and mis-valuation, arising from incentives (bonuses, fee structures) for managers to acquire assets and to overbid for rarely available assets. In turn, valuers were pressured into reflecting this mis-pricing in their valuations due to a fear of losing fee income.

In the residential market, a recent study by Levitt and Syverson (2005) examined data on 98,000 Chicago residential sales where approximately 3,300 of the homes were owned by real estate agents. The authors found that agents selling their own homes behaved differently. After controlling for location, characteristics and condition, the agent's houses stay on the market on average almost 10 days longer and sell for about 3.7% more than houses owned by the people who use agents to represent them. Agents selling their own homes captured both their commission and the homeowner's share of additional prices. Given the commission structure, they conclude that agents deployed their specialised knowledge to maximise their profits rather than those of the homeowners they represented[7]. We need, however, to appreciate the differences between the residential and commercial market. Residential transactions are reasonably straightforward with clear 'expert' and 'non-expert' roles involving a non-repeat transaction.

[6] Beattie et al (1999) distinguish between independence in fact and independence in appearance. The former is characterised by an unbiased mental attitude. The latter is defined as the perception by a reasonable observer that the auditor has no relationship with the client that would suggest a conflict of interest.

[7] It is also possible that home owners may have different risk perceptions and motivations than better informed real estate agents when selling their houses.

4. The cognitive psychology perspective

People buying properties will make judgements against established sets of criteria. In doing this, they will need to search for, select and evaluate information to inform their judgements and support their decisions. This involves reaching conclusions about and choosing between alternatives with different risk attributes; and using information to form beliefs and expectations about what is likely to happen in the future. Understanding how individuals actually behave when forming beliefs and expectations is central to the 'behavioural' applications of cognitive psychology.

People's actions when formulating judgements and making decisions are generally regarded as conforming to the notion of 'rational'. Although rationality has numerous definitions, here it essentially means that people will behave in accordance with the dominant model used by economists for the study of choices about risk, in that they will exhibit utility-maximising (i.e. wealth-maximising) behaviour, conditioned by inherent risk aversion. To the extent that this involves considering the probabilities of alternative outcomes, rational also means that people evaluate these probabilities correctly.

Through a series of investigations, Amos Tversky and Daniel Kahneman (Kahneman and Tversky, 1979; Kahneman, 2000; Tversky and Kahneman, 1974) demonstrated that neither of these assumed axioms is necessarily true.

First, in relation to risk-averse wealth-maximisation, they were able to show that this can sometimes be subsumed by a more dominant force, namely loss aversion (i.e. people will fear 'losing' much more sharply that they value 'winning'). They also went on to show that whether people perceive a decision as involving 'loss' can be manipulated by how the decision problem is presented. Loss aversion has been promoted as an important factor in explaining investment behaviour. It has been argued that it leads to people continuing to hold investments that are performing poorly (at least until they 'get even' – which may of course be never). Correspondingly, they are over-inclined to dispose of investments that are performing well.

The second area of application of Tversky and Kahneman's ideas has been in relation to the use of mental short-cuts in judging the likelihood of events, resulting in flawed judgements. They identified three such short-cuts, which they termed 'heuristics'. The first two consist of placing undue reliance on: (a) the experience of other events that appear to resemble the event being forecast (i.e using 'representativeness') and on (b) events that may be poor indicators but are easiest-to-recall (i.e. using 'availaibility'). The third mental short-cut is the tendency for people, in the process of making judgements, to anchor on what they first think of. For example if the judgement involves numbers, then the anchor is the first rough guess or impression. People then adjust from this anchor as they review new information – but it is typically an under-adjustment.

Manifestations of representativeness have been studied most extensively in the stock markets by focus on how investors react to new information about stocks. This may lead to over-reaction to new information because people see, in a few items of data, a pattern that is not really present. In general, these studies have been of individual investors (rather than institutional investors). A classic study of representativeness causing over-reaction was carried out by De Bondt and Thaler (1985) who argued that representative thinking causes the poorly performing investments to appear more like losers than they really are and better performers to look more like winners than they really are (this is the false 'pattern'). So losers become under-priced and winners overpriced, with losers eventually earning higher returns and winners lower returns. Eventually, over the long-run, this pricing anomaly is rectified.

4. The cognitive psychology perspective

Investigation of the second heuristic, availability, has not been pursued to any great extent in either financial or property markets. An exception is an extreme example of the impact of the availability, in the form of what has been termed 'disaster myopia'. This occurs where people have to estimate the probability of events that are very unlikely to occur. If the people making these judgments have never experienced these high-unlikelihood events, they may be induced by the availability bias to conclude that they have zero probability. Herring (1999) claims that disaster myopia undermines the modelling of credit risk by banks. Since high severity, low frequency events are likely to be the most serious threat to financial stability, disaster myopia increases the banking system's vulnerability to crisis. Herring and Wachter (1999) extended this analysis to the interplay between bank lending and property market cycles, arguing that disaster myopia is an important contributory factor in exacerbating the amplitude of such cycles and the crises that occur as a result.[8]

The third heuristic, anchoring, has prompted several studies of its effects in the property market. Most of these studies, however, have centred on the behaviour of valuers or appraisers, whose processes arguably make them especially prone to this. Specifically, valuers conducting successive valuations of the same property will tend to anchor on their previous valuations. This has obvious implications for the phenomenon known as 'valuation smoothing'.

Other phenomena have been observed in financial markets, such as over-confidence, 'herding', and reliance on investor sentiment. Some of these are attributable at least in part to factors such as loss aversion and/or behavioural 'heuristics'. Various studies have demonstrated that people are inappropriately overconfident in their own judgement ability. Tversky and Kahneman (1974) attribute this to the anchoring heuristic, in that people fail to adjust sufficiently from their initial estimate when considering the range of possible outcomes. Their confidence intervals for their predictions are therefore often far too narrow. Other biasing behaviours, such as self-attribution bias and hindsight bias, may also contribute to over-confidence.

In financial and property markets, the choice that confronts decision-makers is often not that of whether to act, but of what to do when action is enforced upon them. In these circumstances, one way to reduce personal responsibility is to take the same action as many others. While this may not increase the chances of avoiding losses, it will dampen the sense of responsibility for any subsequent loss – by reducing regret. Regret, stemming in part from loss aversion, underlies – though is not necessarily the sole cause of – a phenomenon has become popular as an explanation of aspects of investment activity, namely 'herd behaviour'.

Although herd behaviour is a superficially compelling portrayal of investment behaviour, many of the studies to test for herding by institutional investors have reported little evidence. Herding has not been studied to any extent in property markets. Gallimore and McAllister's (2004) interview study with UK property market forecasters concluded that herding was not a detectable aspect of their behaviour.

8 Herring and Wachter also point out that, once a shock occurs, the availability bias can also cause lenders to flip from disaster myopia to disaster magnification, in which the saliency and ease-of-recall of current or recent events can lead to assessments of the probability of a further decline being over-exaggerated.

5. Summarising the literature

Clearly, the property acquisition decision involves processing a substantial quantity of information under uncertainty; something done by a group of (usually) co-operating individuals whose activities are constrained by organisational structures. The foregoing review of the literature highlights the complex series of factors that may impact on the actions of these individuals.

The dynamic and complicated process of property buying confronts investors with an array of situational variables. This situation is common to industrial buyers. However, as with industrial buyers, there are discernible patterns of decision making that underlie the actions of property investors. The study of these patterns in the organisational buying literature provides several possible ways of analysing the process of property stock selection. Concepts such as the buying centre, joint decision making and the identification of the various decision stages and influences provide tools that to varying degrees may be useful in attempting to explain this process.

It is also clear that the distribution of information and the pattern of incentives can be an important influence on the behaviour of information providers and users in the stock selection process. Agency theory suggests that agency costs are always incurred where there is a principal-agent relationship and is concerned with minimising these costs. It assumes that a number of conditions are met. Firstly, there is a misalignment of incentives; secondly, the potential benefits of a morally hazardous action outweigh the potential costs and finally, there is an asymmetric distribution of information to provide the agent with an informational advantage. In the event that the principal is in a position to identify biased advice and can punish such behaviour, the existence of misaligned incentives will not necessarily produce 'corrupted' decisions.

Arguably, commercial organisations should arrange themselves in order to create appropriate incentives for their employees and their consultants and to control the different risk dimensions in decision-making. In applying agency concepts, however, there is a need to take account of the complexity of incentives in service and advisory functions and the role of non-economic factors and rewards such as ethical and professional standards, the public interest, autonomy and control.

Finally, from the cognitive behavioural bias perspective, linkages with the stock selection decision include the potential use of representativeness and/or availability in selecting information and in screening investments, overconfidence and its components, and the presence or absence of herding behaviours.

6. Methodology

The study described here is based on the speculation there is a gap between what is believed to happen in the stock selection process and what may actually happen. To determine whether, and the extent to which, this is true requires an approach that draws from discussion and conversation with participants, rather than through more remote data collection such as through questionnaires or via inspection of the results of the behaviours (e.g. prices or other market artefacts).

This approach was implemented in the study by using semi-structured interviews. Initially, these were conducted with 19 people involved in the stock selection process, working in 11 different organisations. A further three interviews were later held with introductory agents.[9] Each interview was transcribed and the transcriptions subjected to analysis to relate what people were saying to one or more of the different concepts emerging from the literature (or from prior assumptions of the research team). Identifying, organising and articulating these concepts, and applying them to interpret what people say, is the approach used to derive meaningful results from the investigation. This is a process which occurs not only through retrospective reflection after the interviews are completed and written transcripts become available for study; but also develops as the interviews proceed.[10]

The application of this approach in the present study resulted in the identification early in the interview process of approximately 60 concepts. The majority of these concepts were derived from, and organised around, the key ideas that had emerged as the literature review proceeded. As the analysis proceeded, it became clear that some of these concepts overlapped, typically in representing different perspectives on the same situation. This provisional collection was therefore reduced in number as the process of interview interpretation developed.

To facilitate this interpretation, computer software was used to link the concepts to what people had said. The software used was NVivo (version 2.0).[11] The software does nothing that could not be done manually, though it makes more efficient activities such as the organisation, retrieval and comparison of transcribed passages. The coded transcripts were augmented, however, by the researcher's own notes taken at or in relation to each interview.

9 The managing director of the Propex system was also interviewed.

10 This ongoing process of comparing what is being said, to prior conceptual assumptions, helps in resolving which theoretical ideas are most appropriate or important in understanding what is happening. Stated more formally, the process of comparing existing theory to the data, the modification of theory, and the re-examination of the data against that modified theory, are heuristic, developmental activities. The aim is to identify which theory (or set of explanations) best accounts for what actually happens (Glaser, 1992).

11 In the language of the software, the process was one of creating 'nodes' (the concepts) and 'coding' what people had said (in the transcripts), by attaching this to one or more of these nodes.

7. The sample of interview participants

7.1 Organisations

The 19 initial interviews were conducted in the second half of 2005. The original intention was to conduct 20 interviews, in the form of 10 pairs of individuals in 10 organisations. Each pair would consist of someone working at the fund manager level and someone involved at the asset acquisition level ('transaction specialist'). This distinction held, broadly speaking, for most organisations. As described later, however, these roles more often coalesced to varying degrees; and in three organisations were effectively merged in a single individual. Accordingly, the sample eventually became one in which pairs were interviewed in eight organisations, with a single individual being interviewed in the remaining three (see Appendix A).

Although all the organisations were naturally involved in fund management, the extent and nature of their property portfolios, and the needs of and mandates from their clients, differed considerably. In most cases, these mandates were a mix of both external and internal. External mandates were typically for the management of corporate pension funds (generally, though not exclusively, UK-based). Internal mandates were typically centred on the management of the organisation's linked-life funds and/or some variant of unit-based investment funds, being marketed either at the institutional investor or at the 'man-in-the-street'. No attempt was made via the interviews to formally capture details of the size of all funds under management. The range of size, however, was from below £100 million to (in the case of the larger corporate pension funds) several £billion. The discretion given in external mandates varied from mandate to mandate: from complete, in some instances, to the need in others 'to consult with the client all the way through the process'.

One factor that clearly was influential on many organisations' current and recent activities at the time of the interviews was the state of the investment market leading up to and during 2005. In particular, this impacted strongly in those organisations whose responsibilities included managing the growth of funds based around retail investment products. Another influence was non-UK investors looking to the UK for investment diversification. The obvious ramification of these pressures is the conflict between short-term 'getting the money placed' targets and longer-term performance targets. The universal view was that the weight-of-money factor had been extreme, though perhaps softening in the latter part of 2005. Equally widespread in the interview sample was the belief – perhaps not surprisingly – that these pressures led to sharper, faster decisions, rather than undermining the quality of decisions.

7.2 Individual roles

As noted above, the broad distinction between fund manager and the asset manager, or transaction specialist, was found to be valid in most organisations. This distinction masked, however, quite wide variety in the way in which the boundaries were drawn around the responsibilities attached to each function. In some organisations the distinction was close to that assumed when designing the investigation: the fund manager takes responsibility for overall management, control and oversight of the property fund, with the asset specialist responsible for implementation. Even in these organisations, however, the distinction is sometimes blurred by a spirit of team-working. In other organisations, the simple differentiation of function was either further collapsed, or conversely, further developed. In the former case, the team-work ethic is taken to the point where several individuals collaborate across the functions, with minimal application of a hierarchical framework. Allocation of functions here, though sometimes superficially seeming ad hoc, is aimed at ensuring responsiveness and effectiveness of action.

In other cases, the simple two-level model is developed by splitting the asset specialist function into transaction and ongoing management roles. In a fourth model, the whole range of responsibilities, from running the fund to managing acquisitions and disposals, is performed by a single individual – and it is in three such organisations that only one person was interviewed.

One of the problems in presenting even a general classification of organisational role structures is that of clarifying role descriptions and actual functions. In every organisation in the sample there was at least one ‘fund manager’. This role, however, was characterised by substantial diversity across organisations, often reflecting the degree to which team-working was an ethos. Correspondingly, there was also an asset manager role, although this was likely to be even more diversified in its nature. Nonetheless, this simple role dichotomy is the easiest framework by which to initially describe the arrangements across organisations.

7.2.1 Fund managers

A fund manager is seen as the interface with clients, clarifying instructions and strategy, as well, pivotally, as ensuring that these are subsequently implemented. Where appropriate, they act as the interface with the people who are marketing the investment product upon which the fund is based. Given that all organisations have more than one fund, one fund manager may in turn manage other fund managers. A central part of their role is to ensure that essential procedural issues are addressed: processes adhered to, reporting requirements met and financial targets monitored. They may be involved in sourcing investments, via their contacts in the market, but more usually this is initiated by other means. They do not always get involved in assembling the case for acquisition, but very frequently are involved in informally evaluating that case, in an ongoing fashion, as it is developed by others. This may include obtaining approval to adjust forecasts obtained from external sources and controlling or directing what assumptions to build into the cash flow analysis.

Ultimately, fund managers would have to approve the case and then present it either internally or, if required, externally to the client. In some cases, fund managers may also participate in transactions and even ongoing property management.[12] The factor determining the degree of involvement of the fund manager in transactions is generally, and not surprisingly, the size of the unit being managed.

7.2.2 Asset managers/transaction specialists

As we discuss more fully below, there was a distinction between organisations that merged the roles of asset management and asset acquisition and others that separated them. Below the level of fund manager – although some interviewees disliked the notion of hierarchy – there are the people who are more closely involved with implementation of transactions and continuing asset management. On the other hand, there were ‘pure’ asset managers and ‘pure’ transaction specialists. Within each organisation the nature of these roles typically complements that played by the fund manager.

In some organisations, there is a clearer separation of the investment sourcing and fund-strategy-implementation dimensions of the asset management role. Where this occurs, there is a role that is closer to the concept of ‘transaction specialist’, a role ‘geared more to bringing in stock and creating

[12] In some instances clients may prefer reserve property management to an external firm.

opportunities than towards creating value by asset management'. Their role is to see that fund managers get 'to see as much product as they reasonably can'. Beyond this, transaction specialists almost invariably have some input into developing the case for the products they have presented, at a minimum producing the initial cash flow forecast. Thereafter, the extent of this input in individual organisations is determined by the overlapping interplay between how the asset management and fund management responsibilities are actually shared on the ground.

7.3 Organisational characteristics

There are both similarities and differences in behaviours across a wide range of different organisations. One temptation is to attempt to categorise and explain these behaviours as a function of organisational size or nature. There are good reasons why such an endeavour is neither simple nor productive in relation to the findings of this study. Firstly, a number of respondents in discussing their experiences were drawing from other positions both within and outside their current organisation. More fundamentally, it was clear that recent trends such as the growth in external mandates in traditional insurance and pension funds, the expansion of private property vehicles and retail funds and the growth of specialist fund management businesses, has increased the complexity of the property investment sector. For instance, traditional investing institutions such as Standard Life, Legal and General, Prudential, *inter alia,* have launched retail property funds and have external mandates while continuing to be responsible for their 'core' life and/or pension funds.

This increased complexity in the range of property investment products and the roles of investing institutions has, in turn, increased the complexity of organisational structures. As a result, there were important intra-organisational variations in structures as well as inter-organisational differences. For instance, respondents working for a large institution (by total assets managed) sometimes had a wide range of responsibilities for a relatively small property fund. In turn, the other respondent from the same institution may have had a specialist role within a large fund. Given the additional issues raised the relatively small sample size (by number) and the absence of a standardised research instrument, this factor reinforces the limitations of providing a quantitative analysis of the data by category.

8. The organisation of buying

From the above discussion it is clear that different organisations have different models for acquisition and subsequent asset management. Across these differences, however, the pivotal role of the fund manager was a constant.

Each model of organisational buying had its supporters and detractors who, perhaps not surprisingly, promoted their own structure. Those who thought the buying decision ought to be driven by a dedicated buying team cited the current market environment as a key reason. This environment, through the weight of money coming into the market, tends to emphasise the buying role even where roles were combined:[13]

> *"Although my role is supposed to be 50/50 between transactional and asset management, we've had so much cash coming into the fund that it's been 80 to 90% on the buying side and unfortunately 10 to 20% on the asset management." (AAM)*

> *"If you're trying to be competitive out there buying in the market you can't play at it. You have to have people dedicated to doing that." (FM)*

Of course, there are other organisational implications that flow from separating the buying function from asset management. Front-line buyers spend a lot of time cultivating and maintaining links with agents and so, for many, it seemed logical to either have a dedicated team, or individuals within teams, to focus more efficiently on that task:

> *"Ultimately without them we'd still get deals done, it's just that we'd be dealing with 100 different agents out there and a lot more of our time would be taken up managing those relationships." (FM)*

Separating the buying and management functions, however, also brings its own problems and there were equally vocal advocates of combining roles within individuals.

> *"It's their job to source stock, to manage it, and (when it's due to sell) to sell it. So actually they buy property and if they're buying a dog they've got to manage it …they can't just spin it out and leave someone else to deal with their mess." (FM)*

The literature review identified the concept of the buying centre. In the context of this investigation, it is clear that organisations' buying centres vary in two key ways. First, in the degree to which the different roles are represented in the centre (this is largely a question of the presence or absence of those who subsequently manage the performance of the property – 'users', in Webster and Wind's terminology); and secondly, in the extent to which the contributing individuals are part of a different (or the same) team.

Where the role of asset manager is a separate one there are still, to some within the fund management stream, obvious reasons to include the asset manager in the buying centre:

> *"Down the line somebody says 'hang on, this asset hasn't performed' and the asset manager will blame the acquirer. Ours is a more collegiate approach where the fund manager and the asset manager together will buy into it at day one." (AFM)*

[13] The following abbreviations are used to attribute the quotes to general categories: Fund manager, FM; Acquisition specialist, AS; Acquisition and asset manager, AAM; Acquisitions and fund management, AFM; All preceding functions, ALL.

8. The organisation of buying

> *"If they were buying things that the asset manager raised eyebrows at and said 'I can't believe you assumed this. How am I possibly going to perform within those guidelines' then that would make life pretty uncomfortable for someone working in an acquisition team who sits right next to the asset managers to do that." (AS)*

However, while asset managers may be consulted, their influence on the buying decision may be muted, as several interviewees noted the tendency of asset managers to be pessimistic:

> *"They just want the easiest possible job …they want to have as much comfort as possible in the budget to do what they need to do with the building; because ultimately they get judged by its future performance. So they will always try to be slightly more pessimistic than I would be." (AS)*

In many organisations the buying centre includes people from different organisational teams, such as in the three organisations with a separate transactions team. This has implications for communication and raises questions of different motivations. A transactions team is the main point of contact with the agents. They find potential purchases and then are responsible for the initial screening and cash flow for example. The transactions teams become, to some extent, 'gatekeepers' and a first line of deciders.

The alternative is for cross-fund teams to be used for both buying and managing properties. These may be investment surveyors sourcing (and then managing) investments across funds, or may be sector based teams working across a group of funds – buying and managing. In both cases these work with, but are separate from, the fund managers who are ultimately responsible for the decision.

By contrast, where fund manager/investment surveyor teams are responsible for sourcing investments for their own funds, it is focused on one organisational unit, even though there may be several people involved in the buying decision.

9. Approval processes

Systems of consultation and approval are a vital part of the buying process, and give critical functions to key members of the organisation.

9.1 The fund manager

While frequently not involved in the sourcing/first pass cash flow, the fund manager typically contributes to the evaluation process after this initial run. This involves overseeing the testing of assumptions and modifications to models. Often the fund manager will be presented with a standard format document, as many organisations have formalised the presentation of the investment proposal for its journey up through the approval process. These make the process more transparent, making proposals comparable and more easily navigated.

> *"We have templates, it all sounds terribly administrative, but they're presented in the same way. You've got the asset forecast, asset calculator, which does the depreciation, risk awareness …everybody has to fill in the same one. So you're not debating how you approach it. You may be debating the figures that have gone in." (FM)*

There is a strong recognition across all roles that the responsibility for the decision to buy and the basis of the bid rest with the fund manager.

> *"Ultimately, it's always the fund manager's decision. It's their fund and they are responsible for what goes into it. We purely prepare the analysis." (AS)*

> *"For general day-to-day acquisitions it's the fund manager's role to act as a control on what they're seeing." (AAM)*

While there are hoops to jump through in terms of formal approval from clients or the organisational hierarchy, the fund manager is the first pinch-point in the process.

9.2 The investment committee

In all organisations, once a fund manager decides to pursue an acquisition, there are further formal layers of approval in place. Most have some form of investment committee comprising senior fund managers and, usually, the head of research.

> *"Everything goes before an IC, so no decisions are taken in terms of buying or selling, unless they've been through an IC." (FM)*

While in some cases the investment committee has to approve an offer on a property, in several cases it was clear that offers are made and bids put in before the IC is consulted (and made 'subject to board approval').

Only two organisations had no formal investment committee, although they had a system of approval by directors similar to the system in many other organisations. While some investment committees sit as formal meetings and investments are presented by the fund manager or investment surveyor, some do not have this level of formality and operate by a written proposal which then requires the approval and signature of the individual members of the investment committee.

"It's not a formal meeting as such. We build up a set of papers. Once I'm happy with it and X is happy and Y or whoever is also happy that we're going to buy it, then I'll formulate the board papers and everyone signs it. Then once it's all signed it's deemed to be accepted. So there's no formal presentation of the ideas …there's no sit-down in front of 12 people. Which in some ways would be better …often you find you're going over the same ground with successive people in the process." (AAM)

However, sometimes organisations have a system of delegated authority to fund managers or department heads up to a certain value of transaction, above which the deal must be approved by committee (at a formal presentation or otherwise) – and there may be layers of these. These processes and delegated levels of approval are part of the investment management mandate agreed with the client.

As the money flows into the funds and lot sizes increase, several fund managers commented that they are now usually above any delegated approval limits.

"Most of the things that we're buying at the moment we're having to take all the way up in terms of board approval and sign-off, simply because of the asset sizes." (AAM)

Whatever form the investment committee takes, it is seen as an important check on the buying procedure to ensure due process has been followed and that assumptions and views can be justified.

"They'll try and ask questions that they think maybe you've overlooked, and just ensure that the process has been followed correctly and get comfortable with underwriting assumptions that have been made." (FM)

"The IC constitutes the other fund managers, so you're judged by your peers. So the idea of IC is not to judge whether a deal is good or bad, it's just to check that the fund manager has considered everything that should have been considered and that due diligence has been carried out." (AS)

9.3 Client approval

The amount of client involvement in individual buying decisions depends upon the investment management agreement and the degree of discretion that this gives. As already noted, each of the organisations studied generally had a range of mandates. This is another influence on the shape of the buying centre, how it operates and who can ultimately make the decision to buy.

"More often than not you also have to go and get your client warmed up to it. If you've got non-discretionary money you have to get them excited about it, and say 'we're about to go and bid this, are you going to stand by it?' Because the last thing you want to do is secure something on best bids and then the client tells you that he doesn't want to buy it." (FM)

"Over the last few years most of our funds have become fully discretionary, fully discretionary within some broad parameters, but within that they are expecting us to be given discretionary money to go and do exactly what we think with some tactical tilts towards certain areas to get our modest, but nevertheless, out-performance." (AS)

10. Communication within the organisation

As in any organisation, the means of communication were found to be a mixture of formal and informal systems. Regular meetings and the use of systems such as Propex for introductions and transaction management means that information is widely and speedily disseminated within an organisation. This limits the gatekeeper role of those running the acquisition process. Although each team is quite small, regular meetings are generally held during the week. These are not seen as necessarily the main means of communication between team members. Interviewees stressed the role of informal mechanisms, and, in this context, the close physical location of team members was clearly important.

> *"I think different teams work different ways. We're in an open plan format and the people who work on the investment side sit pretty closely to one another. We've got five formalised meetings a week …but if you just relied on those meetings, it wouldn't work, so it tends to be fairly …shouted out, effectively." (AS)*

> *"We all work in close proximity. We work in an open plan office so there's not a formal structure as such. If I'm working on something and I've got doubt, uncertainty, I'd turn my chair, talk to colleagues and say 'I'm struggling with this one', and take counsel from somebody." (AFM)*

This emphasis on informal, continuous communication and how the physical office configuration accommodates this carries through to the discussions between investment surveyors and fund managers. The buyers will often consult informally with colleagues during the buying process, to tap into their expertise and experience. Some of these people may be on the investment committee and so the informal approach may be a precursor to a more formal part of the approval process.

> *"We do swap notes on what's going on. For example we've got a bit of retail warehousing in the fund – we've got a team who do just retail warehousing so even on asset management issues I'd go and see them because they have the expertise of doing it every day." (ALL)*

> *"We do tend to pay a lot of credence to colleagues who have a lot of experience, because certainly before I buy anything I usually talk to a number of senior colleagues and say 'what do you think?' …and that may or may not include a member of the IC." (FM)*

11. Remuneration systems

Reward systems such as individual or team targets and bonuses are important organisational variables that can clearly influence behaviour. The consistent message from fund managers, asset managers and transaction specialists alike is that there is no direct incentive to buy property. Transaction people therefore do not have incentives to buy as much as possible, nor do they get rewarded for simply doing so; there is a general recognition that this would not be a logical way of remunerating, both because it may encourage buying poor stock and also because being able to buy is not entirely within their control:

> *"It's very hard to put a quantifiable evaluation on what I do, because I could spend all the money we've got, but if it doesn't perform, what's the use in that?" (AS)*

There is often a link to the performance of funds and this may be at a fund level, particularly for a bigger fund (or group of funds) with a dedicated team. However, this is only ever one element of the remuneration system and group or company-wide performance is often a feature. It is recognised that good performance is collective and blame cannot always be apportioned for bad performance.

An important part of performance measurement within these organisations is said to be measurement against both subjective and objective annual targets. Thus individuals are assessed against role expectations and targets – how well they are doing their job; which for transaction people could relate to their presence in market and their ability to bring in opportunities.

> *"Their ability to source deals is as important as the number of deals that is actually closed because sourcing deals is entirely within their remit and it's something they control 100%. Whether a deal crosses the line or not ISN'T something they can control themselves, it's a market problem." (FM)*

12. The screening of prospective purchases

The process for initial screening of prospective purchases is centred in almost all organisations on the regular meeting of fund managers. Typically this is Monday morning but it can be more frequent, even daily. It is at these meetings that properties are either allocated to clients and marked for further investigative work, or are rejected. For those organisations who use Propex, it is data from that system that inform these meetings. If there is time before the meeting, asset managers may have collected further information and will brief and verify information with fund managers.

Three principal criteria are used to help make the initial filtering decision. First, there are the requirements of clients, as specified for example in a fund strategy or in the existing composition of the portfolio. This may effectively exclude some prospects on the grounds of type, location, lease pattern or lot size. Second, there is the house view as to the performance potential of different locations, augmented by the collected and shared experience of the fund managers.

The third reason for rejection is that based on the property 'feeling' wrong. Frequently, though not always, this was linked to 'incorrect' pricing. Interviewees who discussed rejection on pricing grounds were confident of their ability to make such judgements, despite having not fully investigated the prospect. To the extent that resources to conduct these investigations are finite, this behaviour reflects a rational approach to their allocation. And experience is likely to improve the fund managers' ability correctly to make such judgements.

> *"There's a high level of instinct goes into this. You look at something and you just know that it's not going to work. And with a lot of money to spend and scarce resources, you're going to direct people to things that you instinctively think will work."*

> *"They get rejected because of a combination of whether it suits the general requirements in terms of lot size and sector, allied with a general expertise or experience led feeling about whether it's an institutional enough location, whether it's a decent enough property at that level of pricing. I would say it's a combination of being scientific and subjective analysis as well."*

In some instances, decisions at this stage appear weighted strongly to subjective analysis and heavily dependent on intuition. One interviewee described the decision as based on:

> *"all those initial kneejerk reactions which are giving us a feel …is it worth further investigation?"*

Although 'kneejerk' here is no doubt intended to refer to the intuitive nature of the reaction, it can also of course refer to its quality. Nonetheless, interviewees appeared to have relatively more confidence in their ability to judge price than some other key factors. Certain responses in this area raise the prospect of overconfidence in judgement behaviour.

> *"We wouldn't turn something down just because it's in the wrong place, but really we know that things like price are completely wrong."*

> *"You know it's over-priced and you're probably not going to spend a lot of time on it. And it's just experience, isn't it, that enables you to make that decision fairly quickly."*

> *"Having looked at a lot of property over the last 10 years …I intuitively know what's fairly priced and what's not."*

12. The screening of prospective purchases

Another reason given to support an initial accept or reject decision was the nature of the selling organisation, which, combined with the decision to sell, was treated as potentially a proxy for the underlying quality of the asset.

> *"There are some people you wouldn't want to buy from. Another institution, for example, would probably be selling it for the same reason as you'd be selling it."*

Adherence to this view would obviously limit severely inter-institutional transactions.

13. The evaluation of prospective purchases: procurement and use of information

Previous research has suggested that, for UK institutional investing organisations, discounted cash flow (DCF) analysis is a standard procedure in evaluating opportunities for disposal and acquisition (Baum et al, 2000). While DCF is an orthodox technique across all business sectors, its widespread application to property stock selection decisions has only been analysed by property academics in the last 15 years.

Most discussion has focused on concepts of value and the key information needs of the cash flow models (Baum and Crosby, 1995; RICS, 1997). There are a number of key inputs needed to estimate the expected cash flow of the asset over the expected holding period. Although rarely explicitly linked to cash flow modelling, there has been a large body of research on some of these inputs such as rental value growth, depreciation and, to a lesser extent, exit yields. Indeed, the study reported here follows from a previous study focusing on the production of property rent and yield forecasts (Gallimore and McAllister, 2004). We analyse below how the forecasts are used within the stock acquisition process and how the other information inputs are generated and used.

Given the existing literature on the cash flow modelling process, we were able to identify in advance the main non-factual inputs into the cash flow:

- Market rent and voids
- Discount rate
- Rental growth
- Exit yield
- Depreciation and capital expenditure

The assumptions made about these inputs influence the future expected cash flows from the asset and the value that is placed on these expected cash flows. The interviews included a number of questions on these variables. Below, we use the interviews to discuss each of these variables in terms of their origin and application by asset buyers.

13.1 Market rent and voids

Establishing the current level of market rent for the asset could sometimes be problematic where the lettings market was characterised by various types of incentives.

> *"The difference between net effective, face rents and rental growth – is it off face rents? Is it off net effective? And that's always a huge topic. And of course there's no definitive answer on this, it's just views, really." (FM)*

> *"There aren't that many letting deals happening right now, so it's quite difficult to guess what the real ERV is. And the ones that are being done are so riddled with different sorts of incentives, it's almost impossible to work out what the true net effective rent is." (FM)*

13. The evaluation of prospective purchases: procurement and use of information

Two clear findings emerge in this section. Firstly, there are substantial indications that introductory agents are a key source of information about the level of market rent.

> *"We rely on the agent bringing that to us." (FM)*

> *"At the end of the day it'll be the introductory agent, or if we've got it direct we'll get someone locally to give us advice on that, because it's that important." (FM)*

> *"They'll certainly come from the introducing agent. We'll have the introducing agent do a lot of work on what's happened in that market, where ERVs are." (AS)*

> *"Well let's say we're looking at a market which we don't know a huge amount about. That would be my role, to go out and speak to the agents, with regard to working the market, to put together a picture and work out what the ERV of the building is." (AS)*

> *"So sometimes it'll come from in-house, other times we would be prepared to use the agents. If you're using the right people they'd have a good feel for it." (ALL)*

The second clear finding is that agents' figures are not accepted unquestioningly and are subject to scrutiny and checking (see section 14, *infra*).

> *"So we use their advice and then temper it with any internal knowledge we've got of transactions. There are some big portfolios here and a lot of internal information so we know where rents are being settled sometimes already." (FM)*

> *"Quite often they'll come from within our portfolios. We'll look at what else we hold in the location." (AS)*

Nonetheless, the interviews suggest that market rent is the input upon which the agent has most influence. Where lease expiries or break options were imminent, however, the agent was also viewed as a useful source of information.

> *"The agent will have first responsibility to have had those conversations with the tenant. But if we don't have an agent we could use some contacts again, that's the transaction team's role." (AS)*

> *"This is where agents are quite useful, again. If you've got a void coming up then one of their letting agents is quite helpful. They know the demand; they know the incentives being granted in the market today; so you can make quite explicit assumptions on your voids." (AAM)*

> *"We all have our niche of agents that we go to. We'll phone someone and say 'we've got this property, this tenant's leaving, how quickly can we let it up?' and they'll say 'the market's fantastic at the moment and if you put it on the market tomorrow in three months you'll have a tenant in there'. We can't keep a handle on that sort of information for every property so we need to know where to get it." (AS)*

By contrast, since buyers tend to have access to a range of alternative internal and/or external sources to check information provided by the agents, some do not use the agent at all to advise on these issues.

13.2 Discount rate

The discount rate is crucial to the estimation of the present value of the income stream. While there is a rigorous theoretical basis for estimating discount rates in the capital markets – the Capital Asset Pricing Model – there are problems deriving risk-adjusted property target rates of return and in their practical and consistent application to property stock selection.

In standard finance theory the discount rate has three components:

- A risk free rate
- An asset class risk premium
- An additional risk premium to account for the risk differential between the specific asset's risk and the asset class risk. This can be positive or negative.

Often a key question concerns how investors should adjust their discount rates to reflect the different levels of risk attached to different property investment opportunities. The RICS Information Paper (RICS, 1997) commends the use of a Partially Explicit Discount Rate, composed of:

- Gilts – nominal or real plus
- Real estate premium (for example illiquidity, taxation)
- Sector premium (planning, structural change)
- Asset premium (covenant, construction)

However, as a 'reality check' it is recognised that there are no well-developed mechanisms for calculating risk premia.

> *"…the market has not developed mechanisms for determining with certainty the amount of adjustment to the discount rate to reflect variations to the risk profile of different properties."* *(RICS, 1997)*

The interview findings confirm many of these uncertainties in establishing the appropriate discount rate. At one level, the problem was relatively straightforward to solve. A common requirement was that the fund should outperform a relative or an absolute benchmark. The former were more common. Normally, the client was the main driver of the target rate of return. This could, however, be discussed and 'negotiated' with the client.

> *"The mandate stipulates what sort of performance is required from you as fund manager. That really dictates what hurdle rate/target rate of return you're after, over what time frame and what out-performance margin, and a margin over what as a benchmark." (FM)*

> *"Different funds have different benchmarks. It depends on the mandate we've got from the client. Some of them are the IPD whole universe, others are down to particular sectors of the universe. If it's a specialist fund it might be just retail property, or it might be just monthly value funds between £70 million and £150 million. It's horses for courses." (AFM)*

13. The evaluation of prospective purchases: procurement and use of information

"It will start at the fund level; each fund will have a target objective set by various investment advisors, so if it's a pension fund normally the board of trustees will take external advice and they set up a hurdle rate or target rate, the market rate plus some amount of outperformance." (FM)

"My fund has a very specific target return to make, so my target return is obvious over five years. My fund has an absolute benchmark; others may have benchmarks tied to the market." (ALL)

In most cases the target rate of return was then adjusted to reflect different sectoral expectations about the performance of a sector and/or the perceived risk of an individual asset.

"You mustn't buy anything that's going to under-perform in that segment. Even though that segment may be underperforming the index over that period or benchmark. The theory being that if you've got your sector allocations right, and you are outperforming the market in those segments, that will flow through to outperforming the index or benchmark." (FM)

"We accept within each individual property is unique and you may be looking at a property that's very risk-free and you'll accept a lower target IRR because there's less risk." (AFM)

"We'll adjust it at the end depending on how risky the asset is. If the asset has a lot of risk (letting, development, etc) you'd put a 200 basis point margin on that figure. And then you'll compare what the asset's doing compared to that total return." (AAM)

"We build up the required rate of return from the house view in terms of the sector and then adjust for things like the macroeconomics, the microeconomics in terms of the time, the specification of the building, the location of the building, any depreciation, the planning, the lease length." (AAM)

"So if we're looking at retail, we might have a different hurdle rate I suppose than offices …We are trying to look at things on a sector by sector level …how does this perform against its counterparts, rather than how does it perform against the rest of the market." (AS)

While buyers had some discretion in adjusting target rates of return, the level of adjustment was usually made intuitively and, unsurprisingly given the difficulties, there was no reference to approaches to quantifying the adjustments. One respondent, however, where risk adjustment of target rate of return was not implemented for individual assets, felt that risk adjustment of the target rate was a necessary part of the process.

"One of the things our research team has been thinking about has been risk-adjusted returns, which at the moment we don't reflect in our cash flow modelling. That's clearly an inadequacy because we devalue or discount retail, industrial and offices at the same rate – that doesn't reflect their relative risk." (ALL)

13.3 Rental growth

Rental growth, especially for long holding periods, is usually one of the most important assumptions in the cash flow modelling. In previous work on forecast production, Gallimore and McAllister (2004) found that users of the forecasts had an input into their production. This was echoed here in the interviews, with a number of respondents pointing out that the buyers have 'bought into' the forecasts already. Gallimore and McAllister, however, also found that application of market forecasts to individual buildings creates dilemmas for forecasters. This is because forecast application requires expert knowledge of the asset and this is usually outside the domain of the forecaster.

Building from this, we find in the present study that the 'house' view of rental growth is generally just a starting point for buyers. In addition to the discretion required to apply a market forecast to a specific building, the vast majority of respondents have access to a range of sources for rental growth. A large proportion use in-house forecasters who also buy forecasts from external providers and in addition, they are usually supplied with rental growth forecasts by introductory agents. Buyers were able to use the discretion inherent in the forecasts and to adjust for specific circumstances. The quotation below sums up the application of forecasts for a number of buyers:

> *"Sometimes you think 'that's a bit high'. And the fund manager can dampen it or think 'from my knowledge of that, being on the ground and seeing what's around, I think that's a bit soft'. So you can vary it, but you then have to justify to the investment committee what you've done. The fund manager and the investment people won't blindly follow the research." (AAM)*

There were, however, a number of respondents who only focused on the ability to adjust the rental growth figure upwards in order to justify an acquisition.

> *"You're quite entitled to go against the house view, so if you feel that the 2% pa rental growth is too bearish, you're quite entitled to put on 4% or move yields in to a greater extent that is indicated in the house view because that's the judgement and value you're looking to add." (FM)*

> *"It does happen. We do look at it both ways, but in the current context of the market it's almost always the other way (upwards)." (AS)*

> *"But we will then feed in with the agents. Especially in London there's a great debate about what's happening in the West End at the moment; if it helps our case we might be more influenced by the agent's view than by our own view. So it is an amalgam of views, especially on rental growth." (ALL)*

While one 'pure' fund manager, when assessing the cash flow projection of a 'pure' buyer, was sensitive to the risk in such adjustment, in another case the justification appeared to stem from judgement overconfidence.

> *"One of my concerns is that you have to be careful you don't get passionate about your property. I try to work out how much of the performance is in those extra rental growth figures" (FM)*

> *"In all the forecasts and appraisals that we run, we probably won't use rental growth that's less than the forecasts. Our forecasts reflect average market and we would tend to be buying better than average or what's the point? As a rule we'd be putting in, if not average, then better than average rental growth." (AAM)*

13.4 Exit yield

Yield shifts are a key driver of property market performance. At the individual asset level, the forecast of the exit yield strongly influences the level of the holding period terminal cash flow. Gallimore and McAllister (2004) found that forecasters were much less confident in the forecasts of property yields relative to their forecasts of property rents. Fundamentally, they were unable to specify robust models because they were dependent on reliable forecasts of changes in the capital market. This was echoed in the interviews conducted in this study, by the users of yield forecasts, who were also conscious of the difficulties of yield forecasting.

> *"Nobody's really got the answer for it. One's got to take a view on this." (FM)*

> *"It's probably very difficult and very risky for someone to put their name to a forecast saying what office yields are going to be in five years." (AFM)*

> *"[Exit yields are] very hard to forecast, really. And it has such a massive impact on your IRR – a tiny shift in yield moves the IRR up and down and lets you achieve whatever target you want." (FM)*

> *"Exit yield is obviously the trickiest to predict …they find that the hardest thing to do, and have been wrong with that more times than they have been with rental growth." (FM)*

> *"It's so difficult to guess, so we suggest that it stays the same unless there's a strong argument to move it." (ALL)*

Similar to rental growth, the problems of yield forecasts are exacerbated by the requirement to make appropriate adjustments for building-specific and lease-specific factors.

> *"The problem with yield inputs is that the yield forecast is for a perpetual 15 year lease in the market, whereas we're always dealing with lease erosion. So while they'll show us a shape of where they think yields are going to go, we still have to make adjustments based on lease erosion and obsolescence of property. There's always more latitude in that, because it's a much more subjective element to the cash flow." (ALL)*

> *"It goes back to the forecasts, saying 'this is the average, and yields are going to move in or out' and then it's looking at the property you're trying to buy, looking at where the yield is today for that property, the market, and then putting yourself five years down the line with five years less on the lease and making assumptions." (AAM)*

> *"Obviously we'll have a view as to where the exit yield's going to go in the market, so you start off following the market, but then the exit yield will depend on how long on the lease, what sort of property it is, how many tenants, is it multi-let? Lots of these things you have to form a judgement on." (FM)*

> *"With exit yield, we'll have house view on what is going to happen to the market yields. Also you'd factor in the fact that the lease is getting shorter and the building is getting older, and maybe also things like structural improvements in that area, a new scheme being built down the road." (ALL)*

Given the possibilities for subjectivity, one organisation's policy was to build up the exit yield automatically from within their bespoke investment appraisal system.

> *"It's made up of the risk-free rate, plus risk premium, minus depreciation, plus (sic) the long run rental growth figure. Roughly, it's a combination of those." (FM)*

13.5 Depreciation and capital expenditure

Despite the importance of depreciation to the returns from commercial real estate, it has been recently argued that the measurement of depreciation and its influence on property performance is poorly understood (Baum et al, 2005). In the property context, depreciation is typically treated as a decline in the (rental) value of an asset relative to the new buildings in the same location. It can affect cash flows in three main ways:

1. Income growth in the asset may be lower than in the location. In terms of cash flow modelling, this would decrease the rental growth of the asset.
2. Expenditure may be incurred on the asset in an effort to counter the effects of depreciation and obsolescence. In terms of cash flow modelling, this would require estimates of expenditure to be incorporated.
3. Capital values will be affected as depreciation is 'priced' by investors. In terms of cash flow modelling, this would affect the exit yield applied to the asset.

Baum et al (2005) highlight the need to appreciate the basis of rental growth forecasts when taking into account depreciation and also point to the inability of widely used appraisal software to incorporate it explicitly into the cash flows. All these issues were raised in the interviews. However, only a minority of respondents utilised explicit quantification of rental depreciation.

> *"Our strategy team's forecasts are done for the newest of the new and there's a program we can run on our systems which you feed in the age of the building and the location and it will adjust it for the depreciation factor that they have worked out is applicable for those buildings." (AS)*

> *"The depreciation figure comes from (name deleted). They provide 'office depreciation is x' and that goes into the model. Depreciation doesn't get tampered with that much." (FM)*

In general, however, adjusting for depreciation was less systematic and more ad hoc. Not all aspects of depreciation were always explicitly accounted for.

> *"It depends on the nature of the building, but yes within our valuation appraisal we will allow for depreciation in two ways. Either just in terms of yield depreciation, because the assets are getting older, or others we will have detailed knowledge of, for example an office building, then we would apply particular numbers against obsolescence factors." (AFM)*

> *"I think we factor it into the forecasts, but not explicitly. The way you do it is you just look at rental growth and increase it or decrease it for what you think the depreciation rate is going to be …it will get factored in in terms of refurbishment costs rather than rental growth." (FM)*

13. The evaluation of prospective purchases: procurement and use of information

> *"That's a $60m question. The depreciation we run can be explicit and can be implicit. There's no hard and fast rule. Generally, it's implicit within the exit yield that we'll apply. However it can be done explicitly by assuming refurb costs or larger expiry voids within the cash flow and keeping the yield the same." (AAM)*

> *"We will build in capex refurbishment over and above dilaps. We'll have yield shift movements, we'll have void rates. Those are the main drivers and they're put into the cash flow." (FM)*

> *"But we don't explicitly model for that in any of the cash flows we do. There's a bit of yield softening that you might put in if you think an asset is reaching the end of its economic life. But that's instinctive rather than research-led or mathematical in any way." (FM)*

Several respondents volunteered that they felt that depreciation was not being robustly modelled in the cash flows, and it is worth noting that the most commonly used appraisal software package – Circle – does not permit an explicit input for rental depreciation.

> *"I don't think the industry is putting enough onto depreciation, especially in the office sector. There's huge numbers on that you're having to throw at." (ALL)*

> *"I think you'll find that in the current market it's not being taken account of …depreciation's not necessarily factored in." (AS)*

Interestingly, the advice of the introductory agent on depreciation and capital expenditure was not mentioned in the interviews. Almost invariably, where the buyer felt that they needed advice on the cost of potential refurbishment, they consulted experts in that area – assets managers with previous experience and building surveyors or quantity surveyors.

14. Stock selection decisions and the introductory agent

14.1 The role of the agent

In the UK, there are typically two agents involved in a commercial property investment transaction. Normally, an agent is appointed by the vendor to find a purchaser. The vendor's agent markets the asset to other agents or, less often, directly to investors. The receiving agents each then select a potential investor to introduce it to. Agents will at any time have both vendor and buyer clients; similarly for any particular client, the agent could be acting in a sale or purchase.

The interviews show that external agents are integral to the stock acquisition process in commercial property markets, playing a key role in sourcing stock for investor clients. They also usually provide a bundle of services in addition to the search function giving; information, appraisal advice and transaction management services to their clients. All this means that an important transaction cost in the asset acquisition process is agents' fees; a fee is paid (up to 1% of the transaction price) if the investor successfully acquires, but is not normally paid if a bid is unsuccessful.[14]

There are two principal ways in which assets may be sold: (i) by going to the open market, which at its most extreme means to auction, but frequently involves a 'best bids' process, (essentially tendering); or (ii) 'off-market'. An 'off-market' transaction is, by definition, less transparent. Arguably, it is also less competitive, since investors are typically offered the asset at a fixed price without having to bid against other purchasers.

14.2 Sourcing stock

This has been identified as a cost to buyers and is a service that is seen as a key role of the introductory agent. In the literature review, it was noted that intermediaries may play a crucial role in reducing the length of search and increasing the intensity of search. In particular, intermediaries may have advantages in terms of economies of scale in information collection. For instance, Elder et al (1999) suggest that for buyers with high opportunity costs, limited market access and short decision horizons, employing a buyer's broker can be an advantage through an increase in search intensity. In the 'hot' market conditions in which the research was undertaken, the emphasis was on the search aspect of the process.

The requirement for stock in specific sectors and geographical areas is often generated by fund managers in combination with research and strategy professionals. Commonly, details of such requirements (outlining, for example, required yield, lot size, covenant strength and unexpired lease terms) are distributed widely to agents in order to generate introductions. While investors and agents agree that this is common practice, the agents suggest that there is a trend of investors preferring to receive introductions and subsequent advice from only a handful of agents. Investors are generally receptive to opportunistic and targeted introductions by agents, who seek to place stock with buyers whom they consider have a high probability of acquiring and often with whom they have established relationships. However, this inevitably leads to frustration for those investors that are not receiving such introductions.

> *"There are some who have their favourite funds and if they get something interesting in they'll give it to someone they've worked with a lot. We do deal with a lot of people but there are one or two big agents who we just don't seem to hear from a lot. That's probably because they're able to find a home for their investments elsewhere." (ALL)*

[14] This is substantial revenue stream for commercial real estate investment brokers. In 2005, sales and purchases within the IPD index had a capital value of approximately £42.2 billion. Assuming (probably conservatively) total fees of 1.25% of capital value (1% is standard for acquisition but is negotiable for large lot sizes), investors included the index spend over £500 million in agents fees. This would suggest that transaction fees generated by total institutional grade space could be over £1 billion in total for the UK..

14. Stock selection decisions and the introductory agent

"I am only going to introduce properties to the clients who want to work with me, where I know what their requirement is and they say that they want me to find them stock. So I'll find the stock and introduce it to them." (AGENT)

In the current market, simply getting to hear about property for sale and being given the opportunity to bid is crucial. So, in order to be in the running, both on and off market, building and maintaining relationships with agents is vitally important to investors.

"It's vital. Eighty to 90% of introductions to new property come from them and to have a good reputation to be able to deliver things quickly …is vitally important …and there are a lot of personal relationships that help things along as well." (AAM)

"Agents will provide the product. When you're looking in markets that you know like the back of your hand and you can make the assumptions, pretty much the sole reason for the investment agent is finding the product. The way that the market works is that the agent will have their principals, where they get the product, and the principals will rarely go direct to another principal. The agent on the selling side provides the comfort that they are getting the best price, because the agent knows who the best buyers for that property are. On the buying side, the agent provides access to the product, which otherwise you might not be able to get." (AAM)

In the off-market situation, the buyer's agent can be pro-active and creative in generating sales that may not be marketed. The role of the agent is valued here.

"Particularly in the market recently, there's been a dearth of stock available on the open market, so a lot of those transactions that we've done 75% of them have been off-market. So we have an agent that knows exactly what they're looking for, they go out and find the product and then it's a case of making the approach to the owner." (AAM)

"But in an off-market situation, the purchaser's agent has a more important role, because they quite often get people saying 'I think this person might sell – I'll go and speak to them about it' and that's where we value the introductory agents. We just don't have the time to be scouting through the market for off-market transactions." (FM)

The introductory agents who were interviewed also highlighted the importance of being pro-active:

"It is about knowing and mixing with as many people as you can, getting as much information as you can, wheedling out detail, coming up with ideas, being creative – saying that Mr X is underweight in this, but Mr Y is overweight – what about if we did this…?" (AGENT)

The transactions cost perspective in the literature review questions the value of the introductory agent in bringing the property to the prospective buyer. There is some sense amongst investors that in competitive bidding situations, where the vendor is often marketing the asset widely, the role of the introductory agent seems difficult to justify.

"If something's going to best bids it's generally right out in the market and you don't need an agent to introduce it to you, you know it's there. Having an introductory agent for something that's on the open market is actually a waste of money – you know the property's in the market, it's just that you might get it early if someone knows that a vendor has an intention to sell." (FM)

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Yet only a small proportion of acquisitions are between the buyer and seller directly or the seller's agent and buyer directly. From the buyer's perspective, this way of buying eliminates the fee to an introductory agent. In terms of cash flow appraisal, it enables buyers to pay more for the asset for the same return.

> *"Yes vendor's agents do [come] to us, and it saves us 1% on fees so we encourage people to do that. In theory you might say 'why don't we do that all the time' but then there'd be no agency market." (ALL)*

> *"There's no reason why it couldn't happen more often. Everyone in the agency market is obviously worried about principals speaking directly and that was one of the problems around Propex originally. People thought it was going to take the agency market out. There's always the thought that you might not be getting the best price for things if you're selling directly instead of going to the market, but I think these things should happen more often …It's a combination of 'this is the way it's always been' and a lack of opportunities to get to know these people. I think it should happen more. Agents don't always bring that much to the table.' (AAM)*

Yet a cautionary note came from an agent, which suggested the control that the agents have over the information flows:

> *"There was a man who became chief surveyor in the '90s at (name deleted) who said he was going to sort all this out and that he wasn't going to pay agents fees of 1%, he was going to pay 0.5%. Within three to six months he changed his mind because he wasn't getting enough stock. The agents took things elsewhere. (AGENT)*

The last comment suggests that a social capital perspective may have some explanatory power and indeed we found that the importance of agency networks to the market cannot be overemphasised. These networks, and the relationships between the agents, to a large extent determine which investors will hear about property and which agents will introduce the property to those investors. Many investors commented on the importance of these networks:

> *"The investment world is one big club, it's mates. It's about who you know and not what you know. It's not rocket science and it's a networking business." (AS)*

> *"Obviously the interface with the agent world is very important and it's a horrible thing but it is who you know, and I hate it but that's how it works." (AAM)*

When asked to act for a vendor, an important role of the agent is to advise on best sales strategy, be it on- or off-market. Clearly, if it is off-market, then the vendor's agent will approach specific potential buyers, usually via another agent. Even when the property is going to the market the vendor's agent will often target specific agents with a view to them introducing the property to particular investors. This is particularly apparent with larger lots.

> *"If we were selling a shopping centre, we like to think that we would know the market for that very well. While we couldn't exclude the possibility that an Irish investor might come in and buy, we would probably target a very defined list of 20 to 30 people and make sure that we got that area of the market well covered initially. Then if word got out and someone else came forward quite strongly we might include them on the list as well. If it is a shop for £5m it would go out quite widely to the market, to other agents as well." (AGENT)*

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"If it gets heard about in the market, and a small time agent introduces it to a big fund and they have to retain that agent, you may get a better bid if they are better advised, so you often will go to X and Y early to make sure they introduce it to that institution – because you know that they as a double act are going to work well together. That is often the case." (AGENT)

The agents who were interviewed stressed the importance of talking to other agents and to investors to work out what is likely to be coming on the market. They also described the common quid pro quo arrangement that they have with other agents which means that decisions on who to tell about opportunities can be driven by the agent's relationships. This, in turn, influences which agent will introduce to which buyer.

Interviewer: *How do you find out that it is on the market?*

Agent: *Because a mate, an agent in the market has told me; a mate at the vendor has told me. They want to give me the opportunity to get it placed with someone.*

"There is an undercurrent of whispers, someone may say – I can't talk about it yet but yes we are working on a West End office building of about £50m and be in touch. So it is whispers, piecing all that together." (AGENT)

An informal 'first past the post' convention is generally observed in recognising an introduction, for which a fee will be paid. However, while investors will pay for the introduction, many resent having to retain someone just because they got to the phone first. Some may split this introduction from subsequent advice, and split the fee accordingly – although the investors suggested that this is relatively unusual.

"I think the difficulty with the introduction system as it stands is that if someone introduces something to me (validly) we are beholden to recognise the introduction, and they may not be the best person to advise us. That's something we struggle with. If it really is difficult, and it's someone who really can't offer anything at all, there's often a conversation to be had to say 'we'll pay you something as we recognise you've introduced this but we don't think you can advise us so we'll pay you a nominal fee' and then we'll bring someone else in." (AAM)

"Because of where we are in the market, there is huge value to an investor of seeing the stock. What he doesn't like is getting a call at two minutes past nine from a one man band and the 9.15am from JLL who are retained to sell it on behalf of the vendor, and then 20 calls subsequently. So they are prepared to pay and recognise the value of a genuine early introduction, off market, or something in advance of it going to the market. If it is something that they think they are going to get anyway, and it is just a question of whether it is 10 past 9 or 10 o'clock, they resent that." (AGENT)

Almost invariably, where acquisition professionals were able to secure the opportunity to acquire an asset without an introduction by an agent, they still felt the need to instruct an agent to provide advice on various aspects related to the evaluation of the asset. Additionally, where a property was introduced by an agent who was considered not to have sufficient expertise in the specialist area, the acquisition professional usually felt the need to appoint another agent in a purely advisory capacity. It is clear that acquisition professionals place significant value on having external advice.

> *"The thing about in-house expertise is that people don't have time to buy your buildings for you. That's why we pay our agents." (ALL)*

> *"…what we're looking for from an agent is the initial headline, saying these are the headlines and if we get to the position where we're bidding then we look for more detail and quantitative analysis." (AFM)*

In addition, although many of the buyers are experienced and perhaps former agents themselves, they recognise the need for a market-focused view and asset specific advice from an agent who is in touch, not only with other agents but also with other investors. Also, larger firms had the benefit of the expertise of other teams, such as leasing in the evaluation of occupier market trends.

> *"They may have greater familiarity with the town you're buying in or the asset, they may have greater familiarity as a firm, they may have access to research that's going to help you." (AAM)*

> *"But also you could argue that the fund manager, he may have been an investment agent for 10 years and knows the market brilliantly, but since he stepped out of the market, one day the market changes." (AGENT)*

> *"They have the macro stuff, they have the house view on the sector and the sub sector perhaps. But it is market led advice, coupled with some research." (AGENT)*

There is also a suggestion that fund managers need advice as security, to backup their decision. This is discussed later in respect of purchase reports.

> *"We got the advice, we got a report we can go back to, with that report comes a one page business plan, so we hoist them on their own petard if something goes wrong. You could argue, they need third party advice in case they get it wrong, so security to make sure they don't make a mistake." (AGENT)*

14.3 Advice, bias and conflict

The nature of the advice required from agents varies between organisations and according to property. For most organisations, the agent is perceived to be the best source of information on the estimated rental value. For a small number of organisations, this may be the end of the agent's input into the evaluation process. However, as we have seen in the discussion of information, it is often the case that co-production is the norm.

The buying process invariably involves a substantial element of unproductive work by both the buyer and the introductory agent. Buyers spend time evaluating assets that they reject or that they are unsuccessful in acquiring. In turn, agents spend time advising clients about investment opportunities that are rejected or not acquired and for which they commonly receive no fee. From the buyer's perspective, this outcome-based remuneration structure has the advantage of reducing the costs of abortive transactions. However, it clearly incentivises the agent to generate transactions, so it should not be surprising if the advice is biased or perceived to be biased. In fact, buyers are well aware of the incentive structure of agents and its potential to bias their advice.

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"Fundamentally the agents working for us are paid on the deal being done not on the advice they give us, which doesn't seem quite right. And they're paid a percentage of the end price, so they're almost incentivised to get us to pay more than we should." (AAM)

"It's a bit of a bone of contention, actually, that agents are rewarded on fees derived from how much you spend. After a while you get to know who those firms are and who the individuals are who act like that. I can think of people who would really push you into a deal whether or not they believe in it. I think what we have to be careful about is when we buy an asset it's still going to be here with me in five years' time …the agent's collected his fee and gone." (AAM)

"As an agent, when you do an IRR (and I can talk from experience) you're looking to find a way to convince your client to buy something." (AS)

"Of course there is a bias – most agents will talk the ERV up. But it depends on the agent – if it's someone you know they won't be pulling the wool over your eyes." (ALL)

"I suppose we have more confidence in what we get from our own people and sources. I've been in private practice and I know those guys are doing a deal and they'll cut every corner to do it. All they're interested in is the fee and once the fee is paid they're no longer there. So I'll get cynical about cash flows that they try to model for me." (ALL)

"Agents are never pessimistic! If anything, they're always optimistic – there's always a way to make it work. I think the balance is, I know from an investment agent's point of view they're likely to be on the optimistic side." (FM)

At another extreme, agents carried out the financial appraisal on behalf of the buyer and/or would send Circle files to the buyer. Agents could often be consulted on a range of assumptions into the cash flow appraisal – void periods, vacancy probabilities, rental growth, exit yield, and refurbishment costs. It is clear from the discussion above that agents do have an incentive to bias their advice to their clients. However, this appears widely recognised as part of the 'rules of the game' by buyers.

Agents similarly recognise the apparent inherent conflict:

"By implication, you only get your fee if you over pay, you have to be the best bid in the market." (AGENT)

"It's strange isn't it that we get rewarded on a percentage of the price we pay, and the more we pay the bigger the fee?" (AGENT)

14. Stock selection decisions and the introductory agent

In the literature review, it was noted that expert oversight can arguably reduce agency costs since a professional agent is less likely to behave opportunistically when the principal has access to the relevant knowledge base (Sharma, 1997). This seems clearly to be the case in property stock acquisition. We can see from some of the quotations that often, buyers had themselves been agents and most buyers are sufficiently knowledgeable that they can identify biased advice.

> *"We're looking after the best interests of our clients so we have to be comfortable with the advice that the agents are giving. We know the market sufficiently well to know what's good advice and what's bad advice and you have to say 'that's bad advice change it' or 'you're not capable of advising' and bring in someone that we trust who've got the longer term interests at heart." (AAM)*

> *"Generally we don't accept everything we're told by the agents at face value. It's our role to check these things." (ALL)*

> *"So I run all the numbers myself. A lot of people ask the agents to do that for them. I do them all myself but I do involve the agent a lot. I'm on the phone a lot, or I'll meet up and …I guess test each other in terms of the assumptions we're making in the appraisal process." (AAM)*

> *"A lot of the time, people are in the business of generating fees and while they're not being downright negligent they might paint a very rosy picture of the building to get us enthusiastic about it. That's why we'd get other information for rental growth and suchlike – but part of the problem is that a lot of this externally-produced information is only going to be a generic level and in terms of individual buildings you're relying on the agent." (ALL)*

Given that buyers are aware of the incentives to agents and that buyers often have the expertise and resources to identify poor advice, agents may adapt their behaviour. Indeed, a number of buyers also noted that sometimes they were advised not to proceed with an acquisition. This tended to provide reassurance to them that the external agents were not acting purely to maximise short-term fee income.

> *"What's nice from our perspective is for someone like (name deleted) to introduce something and say 'this ticks a lot of the boxes' but when they run the numbers say 'no, it's too expensive, it's not for you'." (AAM)*

> *"It's the nature of the agency business that they're paid on a success-related basis, whereas other professional advisors aren't, so they have that inherent bias. As I said before, I think most of the guys we deal with regularly have found out a bit more about this – they say 'it doesn't suit you for these reasons' or 'I don't think we'll get the growth that you need to see'. Quite often I get those kind of calls. I tend to respect the integrity of those guys and feel that if they are suggesting we buy something it's because they genuinely believe in it, not because they see a fee in it. There are definitely some people who don't operate on that basis, though, and there are definitely some who think 'I'll shaft these guys and then move on to the next ones'." (AAM)*

> *"Lots of agents will get to a stage where they say 'I can't recommend you go into that' especially in this market that's very strong. There have been a couple of cases recently where the agents have said 'we think you should be bidding at this level – say 6% – and the new bids are coming in below that – and they say 'we can't recommend you go any lower, we can't justify that'." (FM)*

These findings are consistent with Walter (2003) who, when analysing wholesale financial markets involving professional transaction counterparties and sophisticated institutional investors, found that the asymmetric information necessary for conflicts of interest to be exploited were of relatively limited importance.

14.4 Relationships and reputation

Other possible restraints on opportunistic behaviour by the agent are long-term business and social relationships (Sharma, 1997). In this vein, Malmendier and Shantikumar (2005), after analysing patterns of analysts' forecasts, argued that analysts' incentives to provide biased (optimistic) advice were outweighed by the disincentives of loss of credibility and reputation which could occur with 'expert' investors. There was evidence in the interviews conducted for this study of such a strategy by buyers, to build personal and business relationships with agents whom they trust.

> *"With agents, it's relationship-based so you tend to work with agents whose advice you can trust and who are going to give you advice which is straightforward." (FM)*

> *"…the way I do it is I identify those agents out there who I think are worth their salt, you can trust, and then I sit down with a few agents and we get to grips with what we're looking for." (AAM)*

> *"We'll concentrate on people we have good relationships with, who know how we work, and who are good in that sub-sector." (AAM)*

In the literature review, the difference in incentives between single and potential repeated transactions was discussed (McLeod, 2003). Essentially it was argued that good advice improves the prospects of repeated custom and leads to reputation benefits so that Axelrod's 'shadow of the future' prevails over current incentives for opportunistic behaviour. This was a repeated theme in the interviews.

> *"The majority of people that we deal with are people that we deal with regularly, unless they push you into a bad one. Word gets round, so …it depends if they're there for the long-term or there for the short-term. Reputation risk is very high." (AFM)*

> *"It comes back down to a relationship thing if we feel that agents are being less than helpful …If we bring a property into the fund and it performs very poorly and that agent consistently does that, you're going to wonder if it's a good agent to use." (FM)*

> *"I guess the control is reputation. Because an introducing investment agent is remunerated on deals done, their focus is on building up and maintaining a good relationship with fund managers so that they know who is buying what …If they shoehorn a client into a deal and the client isn't happy about that, the client will be much more reticent about using them again. Fundamentally it's a small marketplace, and it gets round the market quickly if people are acting the way they should be." (AAM)*

> *"We've got some relationships going back 15 years and longer. Those guys tend to be the ones who stay on board, and if you have a property for five or eight years, they'll retain an interest in that holding and try to come up with new ideas for adding value. They're not just suggesting we buy it and then sell six months later." (ALL)*

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Similarly, the agents constantly referred to the importance of relationships with their clients and the value of having a good reputation with investors for continuing business (buying, selling and, with larger firms, for other aspects of their business)

> *"A good agent will always try and provide the best advice to his client because his is looking for the long term. I would say this – but we are not here for the next 12 to 24 months, we are here to build a reputation over a long period of time. If you do bad deals, you get the old adage – it takes a decade to build a reputation and two minutes to lose it." (AGENT)*

> *"The central message is that we are here to provide top quality advice and if that means that we lose a deal on occasions then so be it. I do honestly believe that if you operate a business like that you build a cutting edge business because ultimately people will come back to you. They will see that you are not just there for the deal." (AGENT)*

> *"The counterbalance to that [fee based on purchase price] is the long term relationship. Whilst we don't live with the consequences of a purchase in the same way that our client does because they live with it every day in the books, and they have it valued quarterly or annually and know how it is performing, we are living with that recommendation and the call that we made. If we have been involved in a pup, we know about it, the client makes us know about it and we don't feel good about it." (AGENT)*

It is clear from the interviews that the inter-related incentives to build and maintain relationships and reputations provide a significant counter-incentive to the gain of a (potentially) one-off fee. Nevertheless, properties are introduced to buyers by a whole range of agents. In the absence of prior relationships, the desire to generate fees will often be the dominant incentive for the agent. In this situation, the expert knowledge of the buyer and the consequent limited information asymmetry become important factors in the evaluation and appraisal process.

While it appears that there are significant controls on, and/or counter-incentives to, opportunistic behaviour to bias the decisions of the buyers, the interviews still generated a number of concerns about the value added by introductory agents to the search and, more particularly, evaluation process. Among the respondents there was substantial variation in the role of agents in the evaluation and appraisal of assets. While recognising the potential for advice to be biased by the fee incentive, the majority of respondents sought advice from agents. For most respondents, this involved advice on the information inputs and market conditions. A minority used agents to generate cash flows which they would adapt and scrutinise. At the other extreme, agents were used almost exclusively to source rather than to evaluate product.

This duality was manifested in the view of the purchase report. Some respondents viewed it as a useful resource.

> *"It's a fantastic asset management document. With the big firms, you get a fantastic service. You even get their quarterly research documents bound in as well. It's hugely important for us." (FM)*

> *"It's generally a good aide-memoire. It's something that pulls the buildings survey report, the environmental report, the agent's report, the market report all together. So it's good to be able to dip into as and when, as you go forward as you're managing the property." (AAM)*

On the other hand, there was some scepticism about its usefulness.

> *"For taking up lots of space in my filing cabinet! Not terribly much, really. It's self-justification." (AAM)*

> *"It doesn't really add any value, but that doesn't mean to say that I wouldn't want one. The more practical reason for it is that it provides a bible of information. It provides a one-stop-shop to go back to in two years to find out about the alienation provisions in the lease. You don't want to go back to the whole thing. You want to go back to a summary." (AAM)*

These viewpoints reflect the potential pitfall of 'bundling' the role of the agent's search and advisory functions. It could be argued that a great deal of effort is put into generating pseudo-advice which is simply confirming or justifying a decision that has already been executed. Clearly, a proportion of buyers recognise the limitations of this advice.

14.5 Changing technology: the role of Propex

Several writers (for example Bakos, 1998) point to changing technology as having a significant impact on the way that transactions are conducted and on the role of intermediaries. During the interviews we found that most organisations subscribe to a computer-based transaction system called Propex. This is a system whereby investors can manage introductions, track properties and transactions. Agents can also use it, however, to introduce property to other agents or to investors.

As we understand, the Propex system is designed to work with the agents and not against them, despite their initial concerns. It was created because of demand from the institutions for a system to manage introductions and transactions: changes in technology had led to buyers being swamped by e-mails for example from agents introducing (the same) property to them. It is possible for vendors or their agents to advertise property for sale in an open way on the system. This facility, however, is only used for smaller lots. For other property, the communications are much more targeted.

The system is clearly in use as a logging/transaction management system within institutions. However, because of the agents' preference for selective, confidential introductions, it is not used for general advertising of property for sale.

> *"Maybe it is because I have been around too long, but where I am very cynical, it is back to this relationship thing. I know that if a shopping centre becomes available and six people ring X about it, it may get registered by someone relatively low down the food chain on a Propex system, but they will choose who they think can give them the best advice, who their relationship is with and they will just quietly lose that." (AGENT)*

> *"Email, technology, Propex, is creating a system which allows the introducing of one property to the whole market in one go. That is making it much more easy. Ten years ago if I wanted to introduce one property to 10 people I had to make 10 phone calls. Now within seconds I can just e-mail it or put it in Propex and just introduce it to everyone. But I think the relationship is stronger than that." (AGENT)*

It may be that with new generations of people coming into the industry who are increasingly computer literate, and who may not operate in the traditional networking way, this will change.

15. Summary and conclusions

The investigation described in this report was designed against a framework of prior research conducted from the respective perspectives of organisational buying, cognitive psychology and agency and transaction costs.

To interpret behaviour in the stock selection process from an organisational buying perspective the nature of, and relationships between, the different roles involved in the buying process have to be understood. This investigation reveals that, even across a relatively small number of organisations, there are substantial differences in the way in which those discharging the responsibilities interact. Key factors that emerge are the need to be speedily responsive and the importance given in most organisations to different models of team-working to achieve this effect. A further feature, transcending different organisational structures, is the ubiquity of the fund manager's pivotal role. This pivotal role is manifest partly in the fund manager's centrality to the internal and external approval processes.

The organisational basis for stock selection by institutional property investors appears to mirror a classic buying centre (Webster and Wind, 1972). This leads to strong reliance on co-operation and joint decision-making with information, and its associated assimilation, deliberation and resolution, central to the process (Sheth, 1973).

Buyers of commercial property assets are engaged in a complex task of information collection, evaluation and application in order to estimate the investment value of opportunities. In addition to the buyer's own knowledge, this information is typically acquired from a range of external and internal sources. While there are variations between organisations in the balance between the use of externally and internally generated information, no single information provider controls the flow of information to the buyer. In the initial cash flow modelling, the buyer has considerable discretion about the inputs. This can often involve a high level of intuitive adjustment, a necessary consequence of the complexity of the task. As we have seen above, the resultant investment appraisal is then subject to further scrutiny and amendment.

Although the research made no attempt to formally capture the interviewees' prioritisation of information categories, the importance of information obtained directly from other people rather than from less personal sources emerged strongly, aligning with findings from elsewhere in the literature (Moriarty and Spekman, 1984; Gallimore and Gray, 2002). The degree to which there is an information preference between 'non-commercial' and 'commercial' information is not clear, particularly in the light of the role of introductory agents (*infra*). The attitude of investors to information provided by their agents shows an awareness of potential bias resonant of that found by Webster (1968) and others in the wider business context.

All organisations seek to minimise communication barriers through frequent informal contacts between buying centre participants. An important supporting factor here is the close, sometimes open plan, physical configurations within offices The team-working ethos so engendered is not eroded by remuneration systems, which are generally not focused on rewarding narrow activities at the expense of overall team or organisational performance.

A key stage in the stock selection process is the initial screening of possible acquisitions. Given the large number of properties needing to be screened, this process appears to be conducted with a rational trade-off between the level of investigation required and the resources available to pursue this. It is here, however, that individuals may be most vulnerable to biased judgements; and the interviews suggest that, though not widespread, some degree of over-confidence may exist. Beyond this, the investigation reveals little or no evidence to hint that any other cognitive biases are significantly prominent in interviewees' behaviour.

15. Summary and conclusions

Perhaps the most striking findings from this study, however, relate to the role of introductory agents. There are typically two intermediaries involved in a property investment transaction, a vendor's agent and an introductory agent acting for the buyer. Whether buying off-market or by best bids, most assets acquired are first introduced to investors by external buying agents and it appears to be difficult for potential buyers to source stock outside of this system. The agency network plays a key role in distributing information on market activity; hence it is important for investors to have good relations with agents. For the vast majority of organisations, agents then provide advice and information to support the evaluation of the asset, as well as transaction management if required.

The investors recognise the value added by agents who can initiate and broker deals on property that otherwise would not have come to the market. They also value the advice that agents give them in appraising potential assets. From a transaction costs perspective, however, the value of the introductory agent in situations where a property is widely marketed is not so clear.

Buyers recognise that the outcome-based payment system provides incentives for the agent to encourage the investor to offer a high price. However, these incentives are counter-balanced by a number of important controls on opportunistic behaviour by agents. Buyers are fully alert to these incentives, are well-informed about the market themselves and are in a position to scrutinise information provided by agents accordingly. Agents are not unaware of this. There is also a strong counter-incentive in the need for the agents to establish personal relationships and trust between themselves and buyers, to generate repeat and related business and to preserve or generate a good reputation in the market.

Several conclusions can be drawn. Investment firms show a flexibility and ability to adapt their organisational structures and individual roles in response to changing circumstances, including short-term pressures in the market. This is undoubtedly beneficial. The weakness of this is that immediate needs prevail and there is a danger that prioritisation of work to meet short-term goals may be at the expense of longer-term objectives – such as asset management losing out in an 'all hands on deck' approach to acquisition in the current scramble for stock. If this is the case, then valuable asset management opportunities may be missed.

Intermediaries have an important role to play in the investment market. In particular buyers and sellers recognise the value added by agents who can initiate and broker deals on property that otherwise would not have come to the market. They also value the advice that agents give them in appraising potential assets. Buyers also seem to derive security from the advice of an introductory agent, yet it is moot whether legal negligence would be provable, given the complexity of the decision-making process.

The advice and transaction support that introductory agents provide, in addition to their procurement role, comes at a substantial price. Additionally, where assets are widely marketed, the efficiency of the sourcing role of the introductory agent is less clear. It could be questioned why vendors' agents do not more often approach buyers directly. The answer may be that the process of linking vendors with true prospective buyers would be performed less efficiently than through the intermediary filter of the introductory agent. This is naturally the view strongly espoused by agents themselves. The filter, however, appears to have limited impact, since buyers indicate that a large number of prospective purchases are rejected at the initial stage.

15. Summary and conclusions

Although this study has not probed this area in depth, the dominance of agent networks as channels of information raises questions of transparency. This, allied to the presence of two intermediaries casts doubt on whether the needs of the investors are always being best served by such a system.

There is considerable scope and, indeed, a requirement for subjective adjustment in applying the variables used in the appraisal process. Yet it is difficult to see how any buyer or other individual could consistently bias decisions away from organisational policy, given the collaborative nature of the process and the controls normally in place. However, the strong influence of market circumstances on behaviour is clear. This creates a danger that pressures towards sub-optimal decisions – in the sense of failure to fully reflect and balance both short-term and longer term objectives – both at an individual and an organisational level.

Finally, one hypothesis at the outset of the research was that real estate forecasts might be manipulated within the acquisition process to support professionals motivated by misaligned incentives to transact. This is essentially a concern with operational risk within the asset acquisition process. The study suggests that the operational risks may be overestimated. The potential for poor decision-making at the individual asset level is limited by a number of 'checks and balances' (as addressed, for example, by Sharma, 1997, and MacLeod, 2003). Buyers do rely on agents to identify suitable assets and to provide advice. They are aware, however, of agents' (arguably misaligned) incentives structures and have sufficient knowledge to critically evaluate agents' advice. In addition, they tend to use agents with whom they have an established business relationship. The agents, in turn, are partially incentivised by the possibility of repeat business. Within the buying organisations, there is recognition that buyers should not be rewarded by volume of transactions. Their remuneration is normally linked to corporate and team performance rather than just individual performance. Lastly, the decision-making process is invariably joint. Initial recommendations and evaluations are closely scrutinised by fund managers and/or committees of senior, experienced experts.

The findings of this study reflect the circumstances of a particular group of buyers in the market (UK institutional) at a particular point in time (2005). In interpreting these findings, it is obviously important to consider whether different outcomes might exist in different markets and in future, changed circumstances. The generally positive conclusions about controls and organisational arrangements reflect a sophisticated market, a well-developed underpinning of professional preparation by typical participants and a strong regulatory framework. These conditions may not all be present in other markets. Nor does this mean that current arrangements are protected from the pressures of change. Arrangements in markets exhibiting similar characteristics, such as the equities market, have obviously evolved dramatically in the past 25 years or so. The key factor in this may well be the role of advances in information and communications technology, and in the extent to which these come to outweigh – or not – the strength of the networks of 'social capital' upon which UK property stock selection processes are currently centred.

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Appendix - Organisations interviewed

Name	Number interviewed
Arlington	2
Hermes	2
Insight	2
Invesco	2
L&G	2
LaSalle	2
PruPIM	2
SWIP	2
AXA	1
F&C	1
Standard Life	1

Investment Property Forum
New Broad Street House
35 New Broad Street
London EC2M 1NH

Telephone: 020 7194 7920
Fax: 020 7194 7921
Email: ipfoffice@ipf.org.uk
Web: www.ipf.org.uk