ST. BRIDE'S
sb MANAGERS

The Navigator

Issue 4 – Winter 2013

Seventeen Short Stories

Articles

All the contributors above are lead-advisers to St Bride's Managers and hence 'qualify' as members of the St Bride's 'Navigator Club'.

Introduction

When someone mentions '2012' to you in years to come, what memories will it conjure in your mind?

Some obvious subject headings: The Queen's Diamond Jubilee, civil war in Syria, the US election, new leadership in France and China, the Facebook IPO which promptly halved in 'value', the BRICS running out of puff and British people staying enthusiastic for a whole month courtesy of the Olympics and Paralympics!

However even in January 2013 it's pretty scary how quickly so many 'memories' of 2012 have already faded. Would you, when asked what you remembered about 2012, have mentioned Manhattan being evacuated, the Leveson inquiry, the disarray at the BBC, the resignation of Andrew Strauss, naked Prince Harry, Felix Baumgartner's jump from space, the 'cash for access' scandal and not to mention 'pastygate' and 'plebgate'? All these were huge talking-points at some time during 2012. Most already feel like obscure historical footnotes.

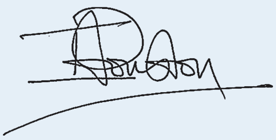
There will, inevitably, have been deeper themes, turning-points and watersheds for which future historians will use '2012' as shorthand. However it's still far too early to pick them out. That said, for us in the property industry, the end of 2012 and the beginning of 2013 is likely to be remembered as a turning point, a time when the consequences of the global financial crisis slowly started dissipating and there really was, finally, some light at the end of the dark tunnel.

The year of 2013 will, in our view here at St Bride's Managers, be remembered as the year:

1. The UK economy started showing signs of a recovery;
2. International capital continued pouring into London (The World's Number 1 City) at record levels in search of trophy assets;
3. The pricing gap between assets in London and the rest of country looked too compelling to be ignored;
4. The mismatch between vendors and buyers aspirations became manageable;
5. The residential sector finally emerged as a significant institutional asset class;
6. Investment in property 'alternatives' and social infrastructure continued to grow;
7. More nails were hammered into the British high street coffin;
8. Bank debt started reappearing;
9. Investment volumes surpassed 2012 levels; and
10. The word 'development' re-entered the property dictionary.

In conjunction with our predictions above, the contributors to this fourth issue of The Navigator have produced articles on the implications the recession has had on the property industry (from their business perspectives) and outline some of the opportunities they see heading into 2013 and beyond.

We hope you enjoy reading this publication and best wishes for 2013.



IAN HOUSTON
PARTNER
ST BRIDE'S MANAGERS (UK)

Property insurers building on changing attitudes

The insurance market has had to review its underwriting strategies across many of its product lines worldwide, including its approach towards the UK property owners market.

JULIAN MUNGO – MANAGING DIRECTOR – AQUILLA INSURANCE BROKERS LTD

Throughout the recession, the property insurance market has remained a very competitive market and the following overview summarises our findings from dealing with composite insurers who specialise in the property owning market.

- Insurers – There are now more insurers with specialist property teams than there were, even only three years back, including the likes of Ecclesiastical, Mitsui, NIG, Amlin and QBE. These 'new' insurers have aggressively challenged the established markets to gain their share and this has helped to have a positive effect, especially on the cover provided and the premiums charged. High risks or poor performing properties, either in isolation or as a portfolio will now have fewer insurers to ultimately choose from, as Underwriters have become far more selective in what they see as difficult or uninsurable risks from each of their perspectives.
- Policy Cover – The 'All Risks' policies offered to the property owners' market has for many years been incredibly wide and flexible. In fact, all insurers now offer an expanded breadth of cover compared to even a few years back.
- Cover Restrictions and Excesses – Property owners with good quality risks which are well run and perform from a claims perspective, will have probably seen little to worry them. However, those with an increasing proportion of vacant properties, those in less desirable areas, or in need of some 'TLC' will see larger excesses, more attention to risk improvements and cover restrictions from their insurers.
- Premium Rates – These are still very competitive despite the fact that most insurers have wanted to raise their rates for several years now. The 'new' insurers have ensured these are kept to a minimum.
- Risk Management – There is a much larger emphasis on risk management imposed by insurers. Owners with poor property risks face much larger bills to maintain their premium levels, extended covers and low excesses. Where these are not being met by owners, policy terms are increasingly being applied.

Conclusion

The overall insurance solution is now probably better for the discerning property owner with a good selection of well managed, fully occupied properties.

The problem is that there are an increasing number of owners who may not fit that 'point of perfection'. Nevertheless insurers will generally try to be accommodating, although in truth, whilst insurers have always struggled with poor risks, they are now more willing to decline those risks which do not fit their preferred underwriting criteria.

Wall of regulation impedes Financial Services Industry

Five years ago UK real estate prices were at their peak, interest rates were (relatively) high, banks were lending money pretty freely (we were seeing 'covenant lite' deals and even loans against the completed value of projects that were still to break ground!).

MARK BALDWIN – PARTNER – MACFARLANES

The UK was experiencing boom times and everyone in the real estate industry was looking forward to an expected tidal wave of real estate investment trusts (REITS) following the introduction of the new REIT regime in 2006.

Five years on and how things have changed! UK real estate prices (apart from in the prime central London residential and core commercial spaces) have fallen or struggled to hold their ground, interest rates are at an all-time low and banks have not been lending. Investors are searching hard for safe and liquid places to put their money. Fund raising is very difficult, although we are seeing some new types of fund - such as debt funds, many of which are 'shadow' banks offering facilities businesses have previously looked to banks to provide.

Probably the biggest change and one the impact of which will stretch out beyond the current economic cycle, however, is the wall of regulation now facing all of us in the financial services industry.

As lawyers we should not complain – the challenge of new legislation and regulation provides us with the opportunity for new work. Existing clients need to understand the implications of the changes and some clients want to take advantage of the different landscape. Responding to that need has filled the gap (at least for many tax and financial services/funds lawyers) left by the receding tide of corporate and real estate deals. Despite that the next year or so is going to be difficult for all of us. The legal profession is no more immune to the chill winds of economic downturn than any other business.

The feeling that the financial services sector (in particular 'casino' investment banks and aggressive fund managers) were at the root of the financial crisis has led to virtual suffocation by regulation. In the UK we have seen the FSA's remuneration code, the bankers' bonus tax and the bank levy (which is used by the government to offset the effect of corporation tax reductions for the rest of the economy). The effect is even more marked at the EU level, where we have the Alternative Fund Managers Directive ('AIFMD'), which needs to be implemented by 22 July 2013 (unless it is delayed) even though the Level 2 provisions were only issued on 19 December 2012.

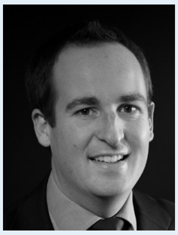
Asset managers are also facing MiFID II and the implications of the bolstering of regulatory capital provisions in AIFMD and Solvency II.

The government's need to bolster its resources (partly to cover the cost of rescuing financial institutions, but also to make up the otherwise inevitable decline in public revenues) has led to quite a fundamental change in attitudes to tax. From being very much a secondary, technical activity, tax has been thrust into the spotlight. The Times' exposés of personal tax planning by high profile individuals and corporations and the zeal with which those have been taken up to politicians (with, in the case of Starbucks, real popular commercial/customer response) show how dangerous it can be to be out of line with popular sentiment. This has justified the government's decision to introduce a general anti-avoidance rule (GAAR). The GAAR has been knocking around as an idea in the UK for almost as long as the author has been in practice, but in the current climate it has finally gained traction. The GAAR purports to be targeted only at extreme, 'abusive' structures, but inevitably it is drafted more widely and there is currently no consensus between the business/advisory community on the one hand and other stakeholders (such as the Revenue and 'tax activists') on the other about where the borderline should lie. To say that the 'guidance' published just before Christmas lacks sophistication or any evidence of clear thinking is an understatement.

There is a great similarity between the regulatory and tax responses to the current climate. Driven by political or media desires to 'name and shame' and find scapegoats, both have spawned 'blockbuster' measures which have been produced far too quickly and with the creases (crevasses in some cases) left to be ironed out once the headlines have been won. The continuing saga of the UK's new high value residential property regime is an evolving example of this. This eruption of law is providing focus and work for our advisory practices. Whether our efforts (or the measures that have triggered all this activity) are energy well spent is a different issue. The object lesson for governments in all this is another growth area in our practice – advising highly skilled and productive French citizens moving to the UK, to escape a punitive tax system.

Six key factors affecting successful property management

Outlined below are some of the changes, opportunities and challenges which have arisen in the world of property management during the last five years.



JAMIE SNARY – DIRECTOR – M J MAPP

Asset Management is the new yield shift

The last five years have seen an increased focus on asset management. Investors can no longer rely on the value of properties and portfolios increasing simply through a shift in yield. Comprehensive asset management strategies are now required for all properties to ensure value is being unlocked through a range of asset management initiatives.

Close relationships with occupiers is key

Close relationships with occupiers generate opportunities for deals. By having strong ongoing relationships with occupiers and by knowing and understanding their business, the likelihood of being able to successfully generate asset management deals is much greater. Close relationships however only develop by spending time with occupiers; in short, it means getting out of your car and knocking on doors when carrying out property inspections!

Retention, Retention, Retention

Retention of existing occupiers and income has never been more important. A happy occupier is much less likely to exercise their break option or vacate at expiry. A first class management service helps retain occupiers and makes their decision to renew their lease much easier.

Outsourcing and Consolidation

There has been steady outsourcing of the property management function within large corporate organisations during the last 5 years. There are a number of reasons for this including the reduction of headcount and costs, with the function being able to be carried out more cost effectively by specialists elsewhere.

There has also been a continued divergence between those surveying firms offering a full spectrum of property services and those specialising in a niche service. We believe this consolidation will continue over the next five years.

Sustainability and Fees

The approach taken to sustainability initiatives has changed. The majority of property investors are now only carrying out those initiatives which are either able to show a direct financial return on investment or are statutory requirements, e.g. CRC data collection and reporting. There is no longer room for the ‘nice to have‘s’ simply because they fall under the broad heading of sustainability.

The RICS Service Charge Code has also impacted on property management fees with the requirement for these to be based on a fixed sum rather than a percentage of spend. Generally speaking this has resulted in the fees payable for larger multi-let office buildings decreasing and those in respect of smaller industrial schemes increasing.

Client Accounting

The last five years have also seen an increased level of financial compliance with clients, their investors, banks, trust managers and auditors wanting to know exactly when they are going to receive their rent, how much has been collected at a given point in time and exactly what money has been spent on both recoverable and non recoverable expenditure.

This increased level of assurance, control and transparency is now commonplace with a number of clients and their auditors increasingly requiring access to our management systems so they can access ‘live’ information and review the detail behind the overall numbers.

Real estate investment freeze creates UK polarisation

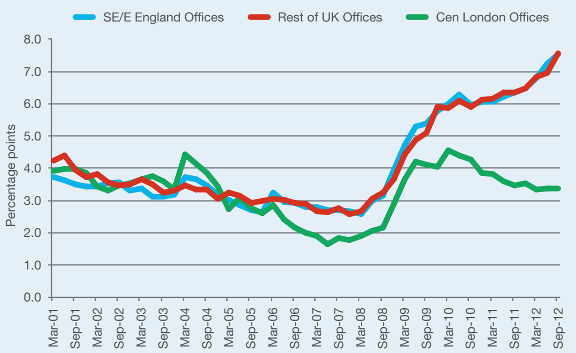
Polarisation is a predominant theme in any discussion of trends in the UK real estate investment market at the moment. The weak economic environment and on-going uncertainty has induced a high degree of risk aversion among investors and this is currently reflected in the highly elevated yield spreads between prime and secondary property.

PETER DANDY – SENIOR SURVEYOR – CBRE

The IPD UK Quarterly Index allows comparison of the average portfolio equivalent yields for properties in the lowest yield quartile with those in the highest yield quartile. Using yield levels as a proxy measure for asset quality, the lowest yield properties can be seen as representing assets nearest to the 'prime' end of the quality spectrum, while those in the highest yield quartile can be taken to represent lesser quality 'secondary' assets. The gap between the top and bottom quartile yields can therefore be used as an indicator of the spread between prime and secondary yields.

Analysing the UK office sector, the chart below shows how the prime-secondary yield spread over the period March 2001 to September 2012 firstly narrowed in the years up to 2007, widened sharply through 2008 and into early 2009 as the market suffered a major correction, and how since then the yield spreads have shown a very marked divergence in trend between Central London and the two regional office market segments. This is a very similar story for the retail and industrial sectors alike.

Equivalent Yield Spreads: Top v Bottom Yield Quartiles



SOURCE: IPD UK QUARTERLY INDEX/CBRE

So what has driven this market polarisation?

1. Economic uncertainty has subdued business investment and investors are shunning properties with weak income security, especially in the regional markets where the economic fundamentals are perceived as less robust.
2. London's status as a global financial and business centre makes the drivers of its economy distinct from those in much of the rest of the UK. There is a degree of investor confidence in the fundamentals of London's occupier markets that does not currently extend to elsewhere in the UK. The narrowing of the yield spread here reflects a more positive appraisal of lesser quality (higher risk) assets by virtue of investors' perceptions of stronger underlying fundamentals.
3. Market polarisation is being further reinforced by the sources and characteristics of investment demand. Purchasing activity is currently dominated by equity-based investors for whom security of income is of primary concern. Availability of new debt for property investment remains highly constrained and focused on secure assets.
4. The dominance of overseas investors and their predominant focus on the liquidity and 'safe haven' attributes of the London market.

Taken together, these factors go a long way to explaining why the prime-secondary yield gap in the UK has opened up as widely as it has. The key questions now for investors is will this polarisation persist and what factors could bring about its reversal?

One factor certainly would be a change in debt markets to produce greater availability of finance for property investment across a broader spectrum of the regional markets and including higher risk assets.

Secondly there needs to be an improvement in the real economy – renewed economic growth and higher business investment to generate a sustained and broadly based improvement in occupational demand. This would provide investors and lenders with more certain income streams and better rental growth prospects. Pending that recovery, the UK market's polarisation looks set to persist. However, investors who have confidence in the prospects of economic recovery may see the present highly elevated yield spreads on secondary property in the UK as a major opportunity. However, this is not the current consensus view which is that the economic recovery will be rather delayed and weak giving rise to a continuation of the polarity described.

Recession is a headache, not a migraine

I don't believe that this recession has necessarily created any greater property opportunity than any other of the major recessions. This recession, as we all know, has hit the nation's books and is therefore structurally the most serious. That said, there seems to be an endless amount of Nurofen to tackle the problems without which many nations would simply collapse.

TREVOR MORGAN – MANAGING PARTNER – MORGAN CAPITAL PARTNERS

Just below the structural problem of countries is business itself and whilst this is fragile in the UK, it is to a large extent alive and functioning quite well. However, many companies have tightened their belts and have reduced their occupational space requirements.

Outside London, the office market since 2008 has seen a significant reduction in occupational demand which as a result has left swathes of empty office buildings. The underlying problem is that nobody has any idea when occupational demand will increase sufficiently enough to tackle this. As a result it makes the decision as to when to invest outside London very difficult to predict, hence those investors that are investing in the regions are demanding a very high yield to compensate for the inherent risks of finding another occupier should the building become empty.

The Central London market is however quite different, as it is not a question of 'if' a building will let but 'when'. The time it takes to find an occupier will depend of a number of fundamentals such as the rental level and the location. We must never forget that the engine of the office property market is the tenant occupier. Without the potential of letting a building, there is little or no value.

Tenant demand in the office sector in London weakened considerably in 2008 and 2009. Rents dropped and rent free periods lengthened considerably and whilst this has now stabilised, demand continues to remain stubbornly thin. Despite this, it is still a much more robust market than anywhere else in the UK and indeed many parts of Europe. The City is the financial centre of Europe and will remain so.

Overseas investors, whether they are sovereign wealth, private equity houses or super wealthy private individuals see the London property market as a safe haven to invest some of their money. This has meant that despite a moderate occupational market, yields have sharpened over the past couple of years for the more conservative investments.

Aside from the simple 'core investment' (i.e. pretty building with a decent tenant on a moderately long lease), the more complicated value enhancing opportunities exist in London but only if you know the market well, you know your business well and you know how to spot them. Plus, you need to be sure you can trust the individual or company that is working with you as it takes a wide range of skills to make it work.

Commercial construction's potential is building

With commercial construction down by almost a third, building costs rising and the General Building Cost Index (GBCI) in an ever-increasing spiral, the commercial real estate sector has to ask; "Is now really a good time to begin a development?"

TREVOR DOWD – MANAGING DIRECTOR – TRIDENT BUILDING CONSULTANCY

The recession has had a massive impact on the output of the commercial real estate construction sector. Activity is down 32% from the highs of 2007.

Despite the reduction in construction output, building costs continue to rise – a 14% increase from the last quarter of 2007 to the last quarter of 2011. Unfortunately the GBCI is ever increasing with the higher cost for oil, labour, transportation and inflation. Manufacturers have cut production capacity in order to assist them in maintaining price levels but further increases are still predicted of between 2.5% and 4% over the next five years.

Over the same time period, the RICS Tender Price Index (TPI), a measure of change in basic construction costs and also an indication of current and future workload and contractor's margins, fell by 11.5%, and it is predicted that there will be a slow and steady increase in the TPI over the next five years, taking us back up above pre-recession levels. However, with the GBCI predicted to rise it would appear that contractors' margins will not increase and, in fact, they are likely to decrease further. All this points to predictions of a slow, steady increase of output, ranging from 2% to 4% per year from 2013 to 2017. However with inflation, materials costs and wages also increasing it will not be an easy ride for the commercial construction sector.

Looking at the impact of the recession on construction activity more closely, there has clearly been a North/South divide in the amount of construction activity taking place. Scotland and the North-West have been hardest hit, with approximately a 50% drop in activity compared to London's drop of 16%, and a drop of 24% to the South-East as a whole.

Of the main commercial real estate sectors it is certainly the retail sector that has suffered most. The pressure on retail around the country and the over supply of premises have ensured that the construction output on retail property has fallen by 27%. London is the notable exception to this. In the office sector output has fallen on average by 16% and the private commercial TPI today is still below the 2007 high.

So what does the future hold?

Market activity is generally increasing and subsequently so will workload within the construction sector. Focus is currently primarily on repair, maintenance and refurbishment of existing stock, although new build schemes, particularly with pre-lets, are apparent in certain sectors.

Is now a good time to start a development? In short yes, so long as occupier demand justifies it. With the TPI remaining low, and increasing at a slow rate, now is the time to prepare schemes and get them to tender. A well run tender exercise can secure competitive development costs and also avoid battles with contractors for future cost increase claims during projects which may otherwise arise due to continuing pressure on contractors' margins. Now is also the time to be improving existing stock, upgrading buildings for sustainability and energy performance purposes, and also catching up on maintenance work where service charge expenditure has been put on hold.

Garden leave for leaders creates new growth

In 1987 The Great Storm savaged my nearby woods at Toys Hill. I remember being at school and people joking that Sevenoaks had become Fiveoaks. In reality it was more like Oneoak. As sad as it was for many (especially Michael Fish), it has allowed new saplings to see daylight and growth starts again.

ASTON WOODWARD – DIRECTOR – OXYGEN ASSET MANAGEMENT

In the 'good years' if you worked for a big organisation or a global entity you were part of a 'market leader'. It was felt that the scale provided security and knowledge to protect investors and deliver returns.

However in 2007 life started to change and from then until now much has changed. Looking back I feel much of that change is positive. Market leaders have disappeared, yet some smaller sapling companies have got bigger and stronger and many are now well-established. They get their share of daylight and, providing their foundation is good, they grow.

For me in business the playing field has levelled. Many of the 'wise owls' that once preached their knowledge have become very good at gardening, spending many a day in anticipation of the arrival of their perennials. Less hardy was their prediction of the market or their will to evolve.

So if you find yourself with the delightful problem of a need to manage an accrued wealth and fancy real estate as an asset class then now is a good time. Many a good asset is being sold by the liquidator/forced seller and the banks, despite much bad press, are still lending money on the right assets. Better still, costs of borrowing with the low interest rate are very attractive and yields on a lot of secondary assets are still moving out.

So the opportunity is to employ someone or an organisation with a relevant skill set and experience. Team up with an organisation, be it big or small that is in business for the long-term and wants to build relationships for the future. Work with people who are genuinely enthusiastic about what they do and watch your assets (if well-managed) flourish over the years to come.

Alphabet Villains

Over the past few years we have all blamed someone or something for putting us in the sad economic/ financial position we now find ourselves in, haven't we? Here are the top 98 that immediately occurred to me over the Christmas break when I was preparing this article… in alphabetical order:

ROBERT HOUSTON – PARTNER – ST BRIDE'S MANAGERS (UK)

A Alistair Darling; Auditors; Austerity Measures.

B Baby Boomers; Bank of England; Basel 3; Black Economies; Bond Yields; Bonus Culture; Brown (Gordon); Budget Deficit.

C Cameron (David); Cheats & Fraudsters; Child Benefit Allowance, Chinese; CMBS; Coalition Compromises; Consumerism; Corporation Tax Dodgers; CPI; Credit Rating Agencies.

D Darling (Alistair - again); Debt.

E Economists; Equities; Euro; European Central Bank; Eurozone; Executive Pay.

F Fannie Mae; Fear; Financial Services Agency; Fiscal Cliff; Fred Goodwin; French (no list would be complete without them).

G George Osborne; Governments (past and present); Gordon Brown (again); Greed; Greeks; Greenspan.

H Hank Paulson; Hedge Funds; House Prices; Housing Shortfall.

I IFAs; Immigration; Income Tax Rates; Indebtedness; Infrastructure (lack of); Interest Rates; Italians.

J Job-shy Unemployed.

K King (Mervyn).

L Lawyers; Lehman Brothers; Lending (too much or too little); LIBOR manipulation.

M ????

N National Health Service; Natural Disasters; Northern Rock.

O Oil & Commodity Prices; Olympics (spending too much); Osborne (George - again).

P Pension Contributions; Politicians (all); Press & Media; Property; Public Sector Spending.

Q Quantitative Easing.

R RBS; Real Wages (declining); Redundancy Pay-offs; Regional Dependency (on Government); Regulators; Rents; RMBS; RPI.

S Short-termism; Spanish; Spending Cuts; Sub-prime Securities.

T Tax Dodgers and Spongers; Tax Thresholds; Tony Blair (for taking us into Iraq and Afghanistan).

U Unemployment Benefits; Union and Trade Disputes; University Fees; US Government (both parties).

V Vulture Funds and Asset Strippers.

W Wages; Weather; Welfare Credits; Welfare State; Winter Fuel Allowance; Wonga (and other pay-day lenders).

X X Factor (and other get famous/ rich-quick shows).

Y ????

Z ZZZZ… Sleeping through the warning siren.

Ummmh! I just wasn't able to come up with anything for 'M' and 'Y'. And then it dawned on me. Of course! 'M' stands for Me. And 'Y' stands for You. We all played our part in the down-fall, didn't we? Let's admit it… we all borrowed too much, or lent too much, or paid too much for something or in some other way contributed. I am not suggesting that we did it knowingly… but there again, nor did those highlighted in my list above. And yet, we nevertheless did contribute. So, it is all very well demanding that our banks, our Government, our regulators and so on get their respective acts together. But have we individually learned from our own lessons, yet? If not, we need to. Only then can we really move on.

Sustainability and the current economy

The UK Government is short of money. It has made a commitment to reduce public sector borrowing and, with the economy in its sixth year of crisis, tax levies are down. Key public services have been cut, unemployment remains relatively high and future economic growth is the subject of much speculation but very little certainty.

CHARLES WOOLLAM – PARTNER – SIAM

Against this background, the Government may struggle to find the £110 billion desperately needed for investment in the UK's energy infrastructure to secure the future availability of supplies. One-fifth of current capacity will be lost during the next ten years through the planned closure of elderly nuclear and coal-fired power stations. The Government also needs to 'decarbonise' an industry which currently contributes nearly 40% to national CO_2 emissions. This will have to be tackled as a priority if emissions are to be reduced by 80% before 2050 in accordance with our statutory obligations.

For the UK property industry, the Government's apparent difficulties in tackling emissions from the production and distribution of energy can mean only one thing. Even more emphasis will be placed on how energy is consumed and, in particular, how existing buildings can be made more energy efficient. If we can't afford to invest in better forms of energy, obviously we will need to use less.

> Even more emphasis will be placed on how energy is consumed and, in particular, how existing buildings can be made more energy efficient.

The Energy Act 2011 introduced the concept of 'minimum energy efficiency standards' and, although the fine details have yet to be announced, the Government has committed to make it unlawful to let poorly performing buildings after April 2018. At present, the Government says that this will apply to buildings with F and G rated Energy Performance Certificates ('EPCs'). According to SIAM's sample of 3,000 EPCs, this could affect over one in five lettable property units.

There has been much chatter in the commercial property market about the likely effect of minimum energy efficiency standards on the investment value of poorly-rated buildings. Many doubt – almost certainly wrongly - that the Government still has the political will to implement minimum energy efficiency standards. Meanwhile, there are rumours that some funds will no longer buy poorly-rated buildings at any price and that some banks will not lend against them. The impact of poor ratings on property values is probably exaggerated. In some cases the cost will be met by tenants trying to sublet rather than by their landlords. In others, the cost of the required improvements as a proportion of annual rent will be low.

Wise investors will consider the risk attached to each EPC rating on its individual merits. A short term price correction may be indiscriminate whilst there remains so much uncertainty about the exact details of the regulations, but many values should bounce back quite quickly, giving brave investors a narrow window of opportunity to pick up some juicily mispriced assets.

‘Fifty Shades of Grey’ - Opportunities for the enlightened

I heard a pundit recently say that with little sign of improvement in the global economy we should perhaps be considering these rather grey times as the new ‘norm’. We at TFT are an optimistic bunch and see this as a glass half-full, ready to be grasped by those with a thirst for more imaginative ventures!

DAVID MANN – PARTNER – TUFFIN FERRABY TAYLOR

Over the past few years we have been proactively helping our clients review their options in this challenging market and advising them on active asset management to enhance the value and broaden the market appeal of their assets. Much like death and taxes there are also inevitabilities with buildings and it is probably no surprise that their propensity to deteriorate over time has been the foundation of the building surveying profession since its birth. I would argue that the rehabilitation and maintenance of our commercial and residential stock not only makes for a sound business case but provides a sustainable approach to combating building obsolescence which has been our raison d’être long before it became part of the green agenda.

We have recently seen a number of buildings constructed during the last development cycle return to the market as their 25-year term leases fall in, with their dated format and specification being unattractive to the existing and potential new tenants. Initially this led to us being engaged in large and complex dilapidations negotiations but, more interestingly, what to do with these properties to address functional, economic, locational and physical obsolescence?

Clients looking at these properties either as existing or potential owners are asking us to undertake a more detailed technical due diligence assessment into their current condition alongside feasibility studies and budget cost planning for change of use, major refurbishment alongside other initiatives such as providing additional floors and making better use of existing floor plates, such as infilling lightwells. Out of the gloom this has presented us with some fascinating challenges and I am pleased to report some exciting completed projects coming to the market and being let.

Other opportunities have arisen from new alternative asset classes. We have been undertaking acquisition surveys, managing change of use projects and monitoring new builds on behalf of clients expanding their portfolio to include student accommodation, hotels, private and social rented residential properties and even prisons.

Our clients are still relatively bullish about speculative office refurbishments in London, particularly multi-let with smaller floor plates.

Out-of-town retail continues to be a growth area for new builds and even the failure of some high street retailers has resulted in a large amount of ‘cut and carve’ refurbishments providing shopping centre managers with opportunities to move tenants around and achieve some large lettings with the likes of TK Maxx, Primark and the budget-end retailers.

Clients are demanding more from their assets and as a result are demanding more from us as their consultants and we at TFT are always up for this challenge.

My buzz phrase for 2013: ‘Building in Sustainability: Designing out Obsolescence!’

Spain in the grip of an investment holiday

The sun may be shining in Spain, but the global economy and the state of the Spanish property market has meant that investment is tepid at best. But well-advised investors could find hot bargains if they respond quickly.

ANGEL RODRIGUEZ – MANAGING DIRECTOR – ST BRIDE'S MANAGERS (SPAIN)

The Current

2012 was a bad year for the major European economies, with the majority of them entering into recession for a second time in four years.

The Global Financial Crisis, coupled with the popping of Spain's residential bubble, has resulted in international investors losing total confidence in the Spanish property market, with the retail sector certainly being no exception. Throw into the mix the high levels of unemployment and a lack of confidence in the ability of the Spanish government to put in place the measures required to resolve the structural economic problems, it is hardly surprising that new investors have either stayed away or are now seriously questioning whether they should be getting out.

The Spanish government has implemented a number of reforms and austerity measures over the last couple of years and these had a negative effect on economic growth in 2012. This lack of growth has directly affected the Spanish property market enormously, with rents reducing even further, vacancy rates escalating (especially in non-prime assets), new development grinding to a halt and the capital markets closing. The numbers of transactions that have been completed have also been very few and far between.

The Future

Projections for economic growth in Spain in 2013 vary between -0.5% and -1.4% depending on which official body is quoted, with no positive growth forecast until the end of this year or the beginning of 2014.

There are however some signs that the bottom has finally been reached and that the tough measures that have been implemented are creating a solid foundation for sustainable long-term growth in Spain. Ten year government bonds are now below 5%, a long way from the 7% recorded in July last year. Spanish companies are again starting to find some sources of finance in the markets, exports numbers are growing, the destruction of jobs appears to have stopped, whilst a number of new retailers are entering the market and making the most of reduced costs.

There are also some signs that investors are starting to look again at the Spanish property market. The significant reduction of capital values from the peak in 2008, the fact that the value gap between buyers and sellers has finally started to narrow, the growing need for investment in existing assets and the lack of time, money and resources to exploit clear asset-management initiatives all mean that a large number of investors will be looking to (or be forced to) sell/find new investment in the coming year. As a consequence, opportunities will definitely appear, but investors will have to be both well-advised and quick out of the gates to pick up the real bargains.

Recession depresses office occupier market

SHOR Associates, as a workplace consultant serving London's financial and business services industry, has been ideally placed to observe the huge impact that the recession has had on the office occupier market.

RICHARD BENNETT – MANAGING DIRECTOR – SHOR ASSOCIATES

The implications of a sharp reduction in employment in the financial services sector has been matched by hesitancy in numerous other specialised business sectors. All of which feeds through to reduced activity in office relocation and office re-organisation with a lower volume of office space to be fitted-out, and lower spend on fitting-out when required.

The reduced vibrancy of the core occupier market in Central London has increased the visibility of emerging business sectors, such as the creative industries associated with technology, media and communications. But these industries have different requirements in terms of location and configuration of the office workplace, and their youthfulness has added visible momentum to changes in the way we work.

The resulting cut-back in demand for office fit-out has suppressed tender prices and increased the risk of insolvency in the trade contractor market. A great buying market with static or falling prices, but a heavier burden of contract administration arising from over-competitive tendering and reliance on claims and other cost adjustments, made more complex by very low fee quotations for consultancy services.

Pushing in a different direction is the prominence of London in the global investment market, giving an upward lift to prime office and residential investment values and a sharp distinction between primary and secondary locations. Prime locations for residential, however, over-lap secondary locations for commercial space, resulting in an almost irresistible case for change-of-use wherever this is permitted.

All of which is evidenced by the observation that some of the niche contractors who previously specialised in office fit-out have admitted that, for the last year or so, their workload has been solely residential. A new experience, and a salvation for many businesses.

The dominant business opportunity pushing its way through all of this is the way we work: a) a huge increase in flexible, collaborative business structures; b) ever-changing innovation in the way we present ourselves and communicate; c) total reliance on very fast communication and response times; and d) greatly improved availability of information through search engines. All summarised by the new business paradigm:

AGILE WORKING + SOCIAL MEDIA

Wealth increasingly divides society

In fulfilment of a rash promise I recently took my wife to one of the newest cathedrals of the modern religion of consumerism, the Westfield Shopping Centre in Stratford.

GEOFF SINGLETON – CONSULTANT TO ST BRIDE'S MANAGERS (UK)

This is far from my natural habitat on the west coast of Scotland but, fortunately, I was afflicted by a flare up of a recent knee injury which meant that, while she browsed and shopped to her heart's content, I remained, largely immobile, in various coffee shops and public spaces in the shopping centre.

Watching the world go by, in what is far from London's wealthiest Borough, I fell to thinking about the retail market and the current recession. On successive weekday mornings, well dressed people scurried to and from glittering shop to glittering store, very many of the high fashion and luxury goods variety, while in the no less busy 1970s Stratford Centre opposite, less glamour scurried purposefully amid reduced glitter where some evidence of strain, in the form of vacant units, though fewer than I had expected, was to be seen.

And I thought about what I was seeing in the West of Scotland on my admittedly few forays to other than the local shops. Here a well recognised phenomenon is entrenched with the life of traditional larger town centres being sucked away into Glasgow and its surrounding shopping centres and malls so that those town centres too are becoming the preserve of the poorer shopper and the poorer shopper's shops.

It seemed to me that I was seeing two things; firstly a growing divide between North and South and, secondly, further evidence of the growing divide within our society based on wealth. It struck me that soon we would see this getting much worse. Although we are almost three years into the Cameron Ministry many of the Coalition's policies, as they strive to bring the Welfare Budget down (or, at least, restrict the pace of growth), will only begin to bite in 2013 as changes in Family Allowance and Housing Benefit come into force and the Universal Credit is introduced. Moreover, as cuts in public expenditure turn into reduced levels of service, the north of the country will be hit hard because of the higher incidence of public sector employment and higher per capita public spending in Scotland.

Without commenting in any way on the merits or otherwise of these proposals it seems clear that considerable pressure will fall on retail during 2013 and that it will be felt hardest in those areas and sectors that lie at the bottom end of the spectrum.

Can small companies thrive in the big boys' shadow?

The biggest issue we face from the last four years is to think how to grow in a market where the opportunities will be limited as we expect both investors and capital to seek the comfort of the large public and private investment companies with a successful track record.

RICHARD SAUNDERS – MANAGING DIRECTOR – ST BRIDE'S MANAGERS (US)

Unlike in previous markets there will be far fewer opportunities for new or small companies to emerge and challenge the big boys. The key reasons for our conclusion include:

- The increasing importance of the Sovereign Wealth Funds as investors. As they have shown to date they feel most comfortable with large/equal partners with substantial capital.
- Growth in cross border investing by the largest and larger institutional investors who similarly want to invest with equivalent partners.
- The efforts by large well capitalized REITs to tap into institutional capital highlighting their advantages of liquidity, tax structuring and knowledge of a local market or sector.
- Pension Funds for ease of control and Investment Managers, Fund of Fund Managers, and funds that struggle to raise new capital, are reducing the number of their advisors to a few large groups that can manage the majority of their portfolio to increase efficiency and preserve cash flow.
- Increasing investor pressure to remove the double promote at the fund level and the deal level with the operating partner. The result is: i) the bigger pension funds will take more of their business 'in house', and; ii) where there are partners they will need to accept less upside and more reliance on fees which again favours the larger existing companies.

So can we overcome these issues? Yes, through recognizing there is pressure to invest capital, be smarter than and identify opportunities that the larger investors miss. This will offer the platform to illustrate added value as an operating and investment partner. Opportunities we see emerging include:

1. Focus on the adaptive re-use of existing properties to increase value. Examples we have been involved with include: i) taking retail to the second floor, ii) converting upper floor offices to residential, and; iii) using a condominium structure to obtain more value from the individual parts.
2. Be consumer (tenant) led. Reflect this in the leasing approach: shorter lease documents; flexible lease terms; single monthly payments which cover everything; affordable good, clean functional space. The end result is the tenant will pay more than 'market' for the efficiency and increase your income and reduce the need for capital.
3. Offices - follow the jobs; keep on top of which sectors are growing or emerging and their impact on office demand and in which cities. For the next few years we see these trends in: Technology, Media/Entertainment/Social Networking, Education, Healthcare, and Private Wealth Management.
4. Retail - follow the retailer; buy urban. This will also open the door to higher yields outside the major cities and in locations where spending is driven through either a preponderance of roof tops or high disposable income the opportunity to buy at a similarly attractive risk adjusted to urban return.

And not one mention of debt. Why? Because it's come full circle and today there is probably more debt available in the US than there are transactions. And the Commercial Mortgage Backed Securities market, widely credited with starting the recession, is once again one of the cheapest and most available lending sources and we predict will grow back to the size it was in 2007.

How quickly we forget. And is that not the story here? Real estate is cyclical and we are close to or are starting a new cycle.

Cash is King

The adage is the same in whatever industry one is in, be it a start-up venture capital business, a firm like Augentius or an investment manager trying to raise a new fund. As 'Cash is King', those that can make the decisions regarding how it is allocated hold all the power.

J.P. HARROP – GROUP HEAD OF SALES – AUGENTIUS FUND ADMINISTRATION

Within the Augentius client base, we gain valuable exposure to what is currently going on within the mind-set of the Limited Partner community, be it for allocations to Real Estate Funds or Private Equity Funds.

A few things have become apparent. When fund raising, managers must listen clearly to the wants of the prospective investor. These investors have many parties willing to take their cash, and frankly demand is currently well in excess of supply. Questions we often hear are:

- What domicile will the investor be most comfortable investing within? Do they have the need for an offshore domicile to be utilised (and if so, which one do they prefer), with the requisite additional costs that come with this, or will a simply onshore structure suffice?
- What type of reporting will the investor want to receive from the Manager, and at what frequency? Will they have specific reporting related to their internal needs which you will need to be willing to accommodate? Would they want an independent Fund Administrator such as Augentius involved in the relationship?

A fund manager cannot have a Fund 2 until they have had a (successful) Fund 1. And it is becoming increasingly common that to successfully raise a first fund, a cornerstone investor is critical to the process. But at what cost should a manager secure their cornerstone? Some cornerstones expect not only a reduced fee arrangement for their commitment, but some are looking for a piece of the management company as well. The mind-set seems to be that without their commitment, the rest of the fund would not have been raised, so they want to share in that success. It seems that a manager's initial instinct is usually to not accept these arrangements, and to try to raise money without such investor on board, but the danger to this is whether they are still interested in investing (at the same terms) when the manager goes back to them.

So 'cash is king', and the key is finding a way to unlock this. There are no magic solutions but listening intently to each prospective investor's needs will certainly only help your cause.

Next time we'll be ready

The property industry in the UK is one of the most sophisticated in the world due to a combination of experience, professionalism, regulation and availability of finance. However, these positive attributes failed to prevent the inevitable downturn happening in 2007 when the flow of finance dried up.

DAVID TUFFIN – CONSULTANT TO ST BRIDE'S MANAGERS LLP

The party's over

Experience should have told us that yields were unsustainable, driven as they were by cheap debt and encouraged by banks focussed on generating ever larger bonuses. Nobody dared to utter a word of caution while the party was in full swing and the Emperor's clothes were so enthusiastically admired.

A global web of inter-bank lending, complicated derivatives, debt risk syndication, lack of transparency and inadequate regulation contributed to the crash and the hangover could last another 5 years. Redundancies, salary freezes, reappraisal of NAV's and 'fire-sales' have ravaged our markets while the herd huddles nervously waiting for someone else to do something.

Reasons to be cheerful

'Any fool can make money in a rising market.' This statement is largely correct, but, when the going gets tough, the incompetent, the inefficient, and the downright dodgy, tend to quit the field and that leaves more space for true professionals in which to operate. Whilst the desperate will initially buy work to keep busy, fee levels will settle in equilibrium with service levels and faced with another 5 years of economic and financial trauma, clients will seek quality in their investments and in their professional advisers.

Those who have survived previous recessions, starting with the 1974 crash, tend to be more sanguine than our younger colleagues about life during the current lean period. When participants recognise and accept the new price reality in our markets, current levels of transactional activity are likely to increase and normality should return, not to the madness of 2006-7, but to the more sustainable pace of 2003.

Overseas investors see the UK and London in particular as a safe haven in a volatile world and the burgeoning demand is helping to underpin prime asset values and if it continues, could lead to a narrowing of the price gap between prime and secondary property.

The Sting

In the UK commercial real estate performance is inextricably tied to economic performance and there are few signs that a significant recovery is anywhere near starting.

ST. BRIDE'S
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