

# Property in Perspective 2004

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The commercial property industry is a very significant part of the UK economy, employing just over 1.1 million people directly (nearly 2 million if you include residential) and contributing over £40 billion to the Exchequer in taxes. At 6% of GDP, it is 6 times larger than the agriculture sector, more than twice the

size of the oil industry and larger than each of the banking, leisure, transport and communications sectors. Accordingly, the success of the commercial property sector has a significant influence on the UK economy as a whole.

### OK, it's a big sector, so what?

Well, apart from the economic argument, commercial property directly and indirectly affects every aspect of our daily lives. Whether at work, out shopping, in the gym or at school, the buildings that surround us play a crucial role in the quality of our daily lives and how productive we are. It is also a significant

investment asset class for the pensions industry and therefore important to all of us in the financing of our retirements. Finally, it also has a critical role to play in helping Government deliver a number of its key social and environmental policy objectives.

### I still don't see why it's relevant to me?

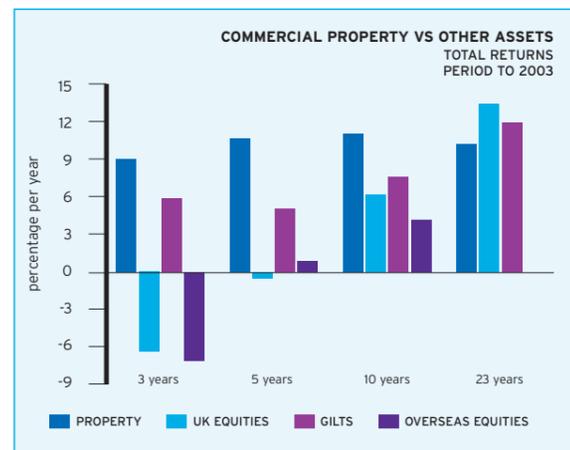
Most people do not realise that they actually own a substantial proportion of the commercial property around them, through their pensions. Research by the BPF and the Investment Property Databank has shown that pension and insurance funds have around 8% (£85 billion) of their assets invested in commercial property. This means that around 15% of the £573 billion total commercial property stock in the UK is owned by the man on the

street directly through his pension fund. This figure rises to 20% if the national corporations, such as the BBC, Government buildings, the Crown and the church are excluded - most of which it could be argued are publicly owned anyway. So the health and vitality of the commercial property sector is extremely important to all of us and we should take a keen interest in any changes to the industry that might have a negative effect on our pensions.

### OK. So property is important to my pension. How is it doing?

Commercial property has been the best performing asset class over the last 10 years to 2003, producing an average total return of 11.1% per year. Over the longer term, 23 years, which represents the start of the IPD data series, property also holds up well, with average returns of 10.3%.

The case for property investment doesn't just rest on its superior returns. Property also offers the opportunity for reducing risk and volatility while providing a strong and stable income flow within an investment portfolio - particularly relevant given the performance of equities over the past three years.

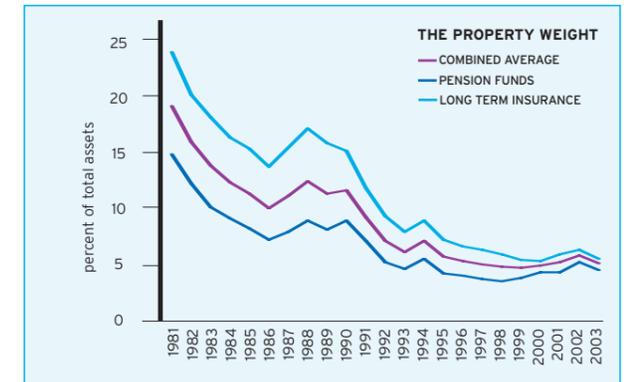


Source: BPF/IPD  
(Data not available for overseas equities for 23 year period)

### Based on those performance figures, why is only 8% of my pension allocated to commercial property?

That's a good question and one the pensions industry and the Government should be asking. A recent MORI survey of private investors revealed that private investors would like to see a much greater proportion of their pension assets allocated to commercial property than is currently the case. Participants revealed that they would expect an average of 22% of pension assets allocated to commercial property and this figure increased to 37% once respondents were informed about how property had performed over the past 10 years. These figures suggest that pension fund trustees and pension fund managers are a long way out of step with their members' wishes. Property's performance compared with equities over recent years has confirmed its merits as an effective risk diversifier, which pension funds have neglected to their cost. Now, with a loss of confidence in rapid capital accumulation via the stock

market and low bond yields, the advantages of property's relatively high, stable and progressive income return reinforces the case for increased allocations to the sector.



Source: BPF/IPD

### What is the Government doing about it?

There are a number of actions that we believe would help. Firstly, the high entry costs of property investment are clearly one reason for pension funds avoiding property as an investment class. These currently stand at around 4% for property investment compared to less than 1% for equities. One solution to this would be a separation of Stamp Duty rates between commercial and residential property together with a reduction in the commercial rate from its present 4% level. This is a solution that the property industry has regularly proposed to the Government.

The other main deterrent for pension funds is the relatively low liquidity of property investments. In addition to being costly, buying or selling a commercial property is a protracted process, unlike equities where transactions take a matter of seconds.

This issue is being compounded by the growing trend away from final salary pensions schemes to defined contribution schemes, as defined schemes have to maintain certain liquidity levels for their funds.

Encouragingly, the Government appears to be receptive to ideas on improving liquidity. The Chancellor's 2004 budget statement included the publication of a Consultation Document on the way in which a tax transparent collective investment vehicle, similar to the US REITs, which the Government calls Property Investment Funds but which we in the interests of continuity refer to as REITs, might be introduced in the UK. In our view, such vehicles will be of considerable benefit to the UK economy, to pension funds and individual savers and to occupiers of property, but in order for them to be successful, they should be kept as flexible and unrestricted as possible.



## How will REITs help?

REITs fill a gap in the investment market and would increase consumer choice. A joint report from the British Property Federation, Investment Property Forum and the Royal Institution of Chartered Surveyors shows that there are few property investment products that fully meet the needs of the small investor market and if more appropriate indirect property investment products were to be created there is a potential pool of additional investment for property of the order of £35 billion from small investors.

The advantages of REITs to both private and institutional investors are that they:

- Enable investors to broaden their investment portfolio and diversify risk;
- Offer a good mixture of steady income with some capital appreciation, which many investors prefer;
- Are more flexible, particularly for smaller pension fund investors, who do not have the means to buy a property or properties for their pension;
- Offer greater liquidity, since investors will be able to trade units of a REIT rather than having to trade specific properties;
- Perform more like a direct investment in property rather than property company shares; and
- Provide a ready-made diversified portfolio of properties, rather than requiring investors to put all of their investment into a single property.

The potential benefits that REITs might provide the UK economy, based on their performance in other countries, are:

- Expand the private rented residential sector, helping to improve labour mobility and housing quality and supply;

- Lower cost of capital for property, either leading to lower rents or the provision of more and better quality property, which in turn should improve choice and flexibility for occupiers;
- Reduce volatility in the commercial and residential property markets. Introducing more equity to the property asset class should help reduce the sector's exposure to debt and the interest rate cycle;
- Increase trading activity within the property sector, which would help grow property's direct contribution to the economy from its current level;
- Bring millions of pounds of assets back onshore, reversing the trend of taking assets offshore, thereby safeguarding tax revenues;
- Provide a potential one-off boost to UK tax revenues if the Government decides to follow the French example of charging an 'exit' tax for existing listed property companies converting to REITs or an entry charge for all companies or funds that convert to REIT status;
- Help businesses release capital currently tied up in real estate and enable them to use the proceeds more efficiently in their core business;
- Stimulate infrastructure development and regeneration, either through the formation of specialist REITs or by providing a vibrant market into which completed developments and regeneration projects can be sold.

## How else does commercial property help deliver Government policy?

In addition to the substantial tax revenue provided by the industry, commercial property plays a direct role in helping Government policy. Take urban regeneration. Without the commercial property sector and its ability to attract private sector investment, most of the UK's major urban regeneration schemes (e.g. Liverpool Docks, Cardiff Bay, Gunwharf Quays in

Portsmouth, Brindley Place in Birmingham) would never have taken place. The same is true of the environment, where innovations on energy efficient buildings and improved energy management policies are contributing towards the Government's targets to reduce carbon emissions.

## Why are you telling us all this?

The commercial property industry is an important contributor to the economy and has a direct impact on the every day lives of most people. We believe it is important that Government

and legislators understand that there are economic, social and financial consequences to any further changes (legislative, tax or regulatory) imposed on the commercial property sector.