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SECTOR REVIEW

Real Estate Primer

Real Estate is an asset class featured in many portfolios, whether directly (physical property) or indirectly (e.g. through real estate equities). Real Estate investors include sovereign wealth funds, hedge funds, long-only funds and specialists. Over the long term, real estate has consistently outperformed UK government bonds and cash deposits and thus still offers a strong investment case, in our view.

As we update our Real Estate Primer for 2010, we look back at the unprecedented financial turbulence seen over the past year with astonishment. The winners march on with even greater confidence, the survivors have learnt a valuable lesson and we say goodbye to some losers.

We regularly meet new clients/investors who are keen to learn about the sector from scratch; hence the need for a Pan European Real Estate primer. We go through the basics using examples to illustrate our points.

The list of subjects covered here is by no means exhaustive and we expect to add to the primer as new items emerge, but it should cover many questions investors may have about real estate markets.

If you would like to learn more about individual real estate companies, we have created initiation presentations for each property company in our coverage universe.

If you have any additional questions/suggestions etc., please contact Vishal Lakhani, Marketing Analyst. We are more than happy to assist with your queries.

Finally, we would like to thank all the organisations, companies and individuals who have assisted in the publication of this document.

– the Credit Suisse Real Estate research team

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Introduction

What is Real Estate?

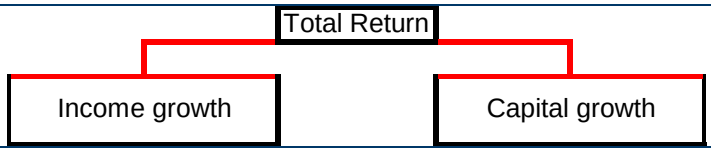
Real Estate is a legal term used for land and attached buildings. The terms 'Real Estate' and 'Property' are used interchangeably. The motivation for real estate ownership falls into two categories:

Real Estate is simply a legal term used for land and attached buildings.

- owner occupation: e.g., requirement for a factory as a production unit or a shop as an outlet for manufactured goods; and
- investment purposes: means of receiving a prospective income and capital return on a capital outlay.

An investor's primary concern is the security of income flow that can be achieved through rent and capital growth of an investment. An investor will balance the risk of default against the attractiveness and likely returns available through investment in other asset classes, such as gilts and equities.

Figure 1: The aim of an actively managed property company is to provide the highest total return



Source: Credit Suisse research

A successful long-term investment

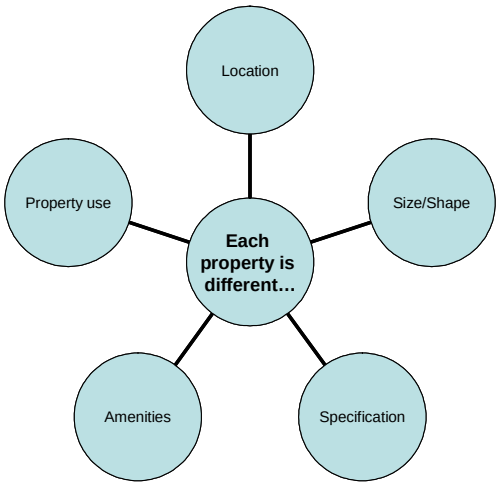
Over the past 36 years, the longest period for which credible data is available, commercial property has produced annualised returns of 12.2%, ahead of both gilts (UK government bonds) and cash deposits.

Source: IPF

Property is generally considered a low- to medium-risk asset (over the long term) and an essential part of a well-diversified portfolio.

Real Estate: An essential part of a balanced portfolio

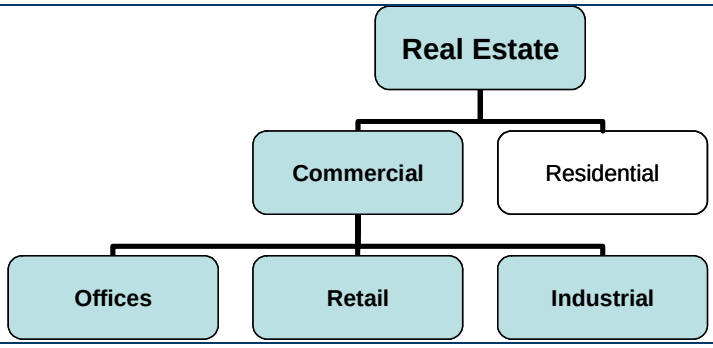
Figure 2: Each property is different…



Source: Credit Suisse research

What are the different types of Real Estate?

Figure 3: Types of Real Estate – The basics



Source: Credit Suisse research

Commercial property

Commercial property is real estate for business use. Commercial property is generally not as well understood as residential property. The focus of this primer is commercial property (which refers to office, industrial and retail property sub-sectors) across European markets.

Each commercial property sub-sector features a range of differing characteristics, from lease structure to valuation methodologies. The risk and return characteristics can also vary and it is important to understand the various sub-sectors discussed in further detail in this primer.

Commercial property is commonly owned by specialist property companies, institutions with long-term horizons and a growing number of private individuals.

Non-commercial property

Non-commercial property includes residential and agricultural land. Residential property is generally the preserve of owner-occupiers; e.g., 12% of UK residential stock is privately rented by landlords.

The main type on non-commercial property is residential

Differences between commercial and residential property in the UK include the following:

- commercial leases tend to last at least ten years, whereas residential leases tend to be for a minimum term of six months, providing less security. Longer leases provide a stable cash flow stream for investors;
- commercial property tends to be significantly more expensive than residential property; and
- the majority of commercial leases are on Full Repairing and Insuring (FRI) terms, meaning that the tenant is responsible for maintaining the property and insuring the building.

We examine leases across the European markets in further detail later in this primer.

Property characteristics

- Property has the advantage of being a physical asset that you can 'touch and feel'; however, this does mean it can deteriorate if not managed or maintained.
- Income streams are generally long term (leases in the UK are generally for 10+ years, but lease terms vary across Europe) and include periodic rent reviews.
- The supply of real estate depends on local (and national, in some cases) government legislation, which can affect planning consent/permission.

Real Estate ownership

In the UK, patterns in property ownership have changed considerably over the past 40 years. The largest property owners post WWII included the Church, the Crown, local and national government and private estates, but a variety of new owners have emerged over the past twenty years.

Property ownership has continued to change over time from the Government to International investors.

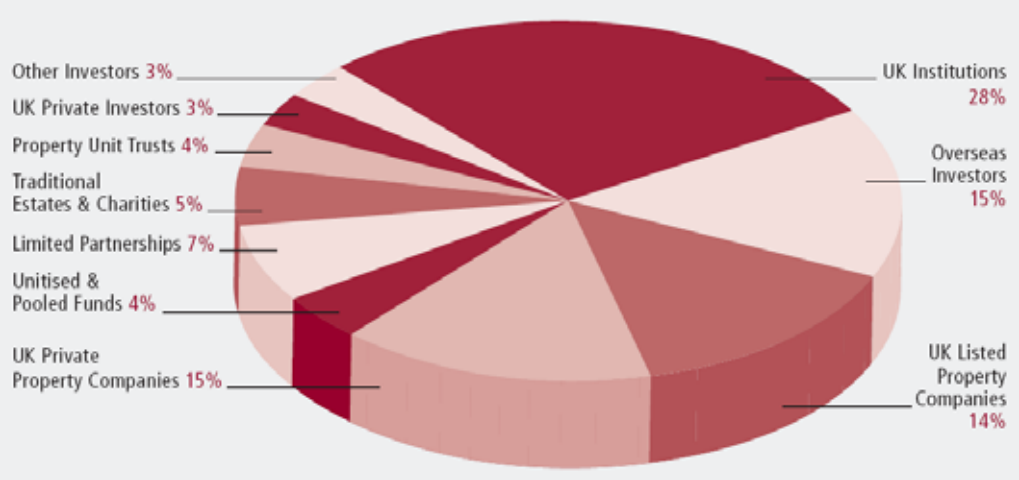
In continental Europe, property is mainly owned by institutions, corporations and private investors.

Property owners now include insurance companies, banks, pension funds, long-term institutions, private owners and overseas investors, as well as quoted property companies/real estate investment trusts (REITs), such as Land Securities. Many of these institutions will have a specific property fund management team to maximise the total returns from property.

Overseas ownership has continued to increase from the early '90s to the present. Overseas investors include:

- German open-ended funds (e.g. DEKA);
- international pension funds (e.g. ABP);
- international property companies;
- Sovereign Wealth Funds (e.g. Abu Dhabi Investment Authority, Government of Singapore); and
- international opportunity funds

Figure 4: **Investors in UK Commercial Property (2007)**



Source: IPF

Investors versus developers

Property investment companies (e.g. Land Securities/Eurocommercial Properties) predominantly focus on owning income-producing property and limiting their exposure to developments, which in growing markets can prove to be attractive opportunities, but can be more risky if the opposite is true.

In the early '90s (UK), when a number of property companies went into liquidation, the majority of the companies that were hardest hit had significant development exposure. A lack of rental demand for their assets alongside a significant increase in supply meant that they were in no position to service their debt, leading to the collapse of many of these companies.

Over time, many of the surviving companies have changed their strategy to focus on an income-producing portfolio with a relatively small development pipeline to increase income and asset growth. This is the case for many property companies across Western Europe.

Many property companies across Eastern Europe and Russia have a greater development focus and have suffered from the recent financial fallout, similar to the situation in the UK in the early ’90s.

Property risks

There are various risks that need to be considered before investing in real estate. Many of these risks are specific to particular assets. Thus large, diversified portfolios can reduce an element of this risk.

Source: Investment Property Forum

Location

Location is one of the most important factors to consider when assessing a property. The right location can command a higher valuation and a higher rent, thus providing a higher longer-term return. Some property investment companies will focus on regeneration locations as capital growth in these locations may be faster than established locations.

Location, location, location…

Physical characteristics

Property is a physical asset and can suffer from 'wear and tear' over time, which can affect its valuation, as work may need to be carried out on the asset.

Like any physical asset, property can suffer from 'wear and tear' – this needs to be considered when evaluating any property investment

Requirements from property can also change over time. For example, when developing an office thirty years ago, air conditioning or space for cabling may not have been significant issues; however, they are integral parts of most developments today.

The use of property will affect its value. A property cannot simply be used as a restaurant or office without the right permission; some properties will not always have an opportunity to change use. A property that can only be used for office space may command a different total rent in comparison with retail property.

Tenants

As stated earlier, the value of a building is dependent on the strength of the tenant/covenant. A tenant that may have appeared attractive at purchase may not be the same several years into the lease. For example, a Woolworths (now a failed general store) covenant was an attractive and 'in demand' asset in 2006; however, a large proportion of those units are empty today.

The quality of your tenant/s can make a difference to your valuation

Lease length

The length of the lease is also an important consideration. If a building is let to a good-quality tenant for a long period, then the rental income is virtually assured even if market conditions for property are volatile. This is one of the attractive features of property investment.

Average lease lengths are getting shorter – they also vary considerably across European markets.

Thus, when buying a property, it is important to consider what the lease length will be when the property is likely to be resold. Many leases include break options and it is market practice to assume that the lease will expire at the break point.

Most property companies will state their average lease term.

Market risk

These are risk factors that can affect all, or significant sections of the property market. Like the economy, commercial property appears to go through cycles: periods of growth leading to oversupply and market weakness, followed by stabilisation, absorption and then growth, leading to shortage of supply and so on.

Key players

There are a number of 'key players' fundamental to the real estate industry.

Source: Investment Property Forum

Commercial property developers

Pure commercial property developers are a rarity today, with the majority of the listed commercial property companies now predominantly property investment companies with development sidelines to deliver asset value growth.

Developers play a key role by:

- assembling sites;
- organising the services of specialists (surveyors, agents, contractors etc); and
- sourcing finance.

Speculative development

Many developers build property 'speculatively'—i.e., they develop projects without a tenant in place to occupy the building on completion. Leasing the building before development start is known as obtaining a 'pre-let'. For example, Land Securities' Park House development fronting Oxford Street in London would be considered speculative development.

The pre-let

Developers often contract to sell schemes on completion (with or without tenants) to property investors benefiting from a development profit. Financing a development is easier where a pre-let is in place. For example, Westfield pre-let part of its Stratford shopping centre with a John Lewis department store and Marks & Spencer.

Adding value to property

Developers/Property investors are always looking at adding value to their assets. 'Active management' is a term used for adding value in the industry. This may include:

- re-negotiating lease terms to increase rents or prolong the length of the lease;
- refurbishing the premises to increase the potential rent; and
- redeveloping the property for a new use; e.g. a property may attract more rent as a retail unit than an office.

Financiers/Bankers

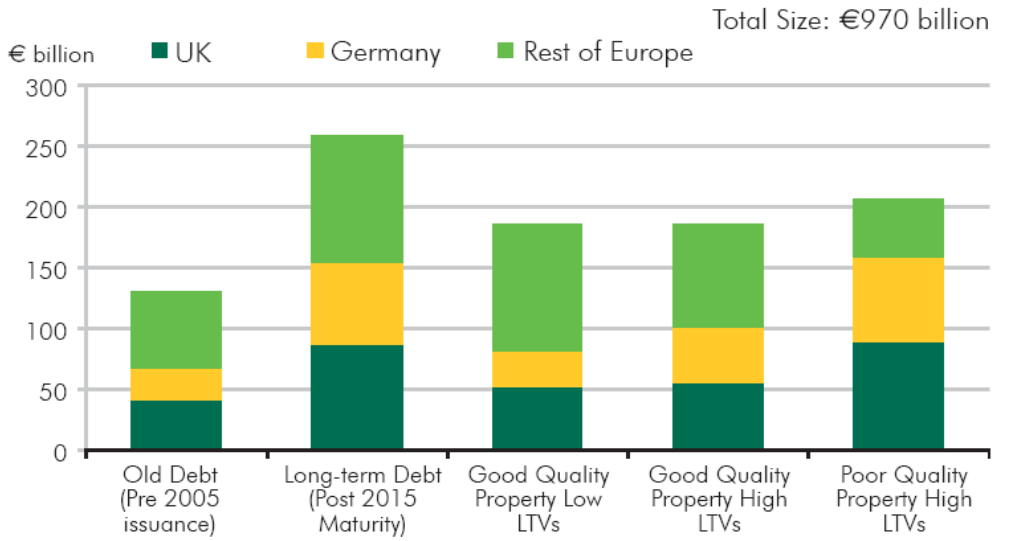
Financiers/Bankers assist by providing:

Real Estate is heavily dependent on the availability of finance

- development finance; and
- property investment finance.

The majority of investors will leverage their equity with an element of debt to improve their purchasing power. According to CBRE, there was £970bn of outstanding debt to commercial real estate across Europe as of late 2009. The Bank of England stated in late 2009 that the total commercial real estate lending by banks was 17% of all lending compared with c.3% in 1991.

Figure 5: European Commercial RE: Current profile of outstanding debt (2010)



Source: CBRE

Financing has proved difficult to obtain since late 2007 as lenders have dealt with the significant write-downs of their real estate portfolios (although this has shown signs of improvement over the course of 2009 and is likely to recover further in 2010). With limited lending in the marketplace, developments planned for the coming years have been pushed back.

Limited (although improving) finance conditions have seen the emergence of 'pure equity' investors who are looking to capitalise on the fall in property values over the past two years. Development finance even now in 2010 is near impossible to fund, and although we think we may see glimmers of hope in late 2010, we currently see limited signs on the horizon.

Occupiers

An occupier can make all the difference to a property. A strong covenant can:

The strength of your covenant can make all the difference to your property valuation

- improve the value of your property as it provides a sense of security for potential purchasers (for example, grocery store, e.g. Tesco, tenants tend to provide a greater sense of security for investors than many other retailers); and
- attract other occupiers to the development (for example, Westfield London was able to draw a number of designer brands upon signing Louis Vuitton to its shopping centre scheme).

The commercial property market places considerable emphasis on the financial strength (covenant) of an occupier. This, along with the lease terms, is critical in assessing both the risk in, and the value of, a property investment. Thus, developers want to let their schemes to good occupiers (i.e., tenants with strong covenants) to maximise the value of the property.

The factors that drive the occupational property market differ from those affecting the investment markets, although it is important to remember that ultimately the investment market is dependent upon the ability to attract tenants.

Property consultancies (e.g. Chartered Surveyors)

There are a number of property consultancies that offer a variety of services to clients. Such companies include CB Richard Ellis, Jones Lang LaSalle, Colliers CRE and Cushman & Wakefield and can assist in:

- marketing properties available to lease, identifying suitable occupiers and negotiating leases for clients;
- negotiating the purchase of properties;
- surveying properties and reporting on their condition and structural soundness;
- managing property for investors; and
- valuing property.

Property ownership

Property is commonly purchased as either Freehold or Leasehold across Europe.

Freehold ownership provides the owner title to the land and buildings for perpetuity. However, this does not necessarily mean that freeholders can do whatever they wish on the site. The title may feature covenants that need to be respected and local/national planning laws still need to be considered.

Freehold – title to land & buildings for perpetuity

Leasehold ownership provides the lessee ownership of the asset for 'x' period of time. In the majority of cases for commercial property, leaseholds tend to be long term (e.g. more than 50 years) and are sometimes called virtual freeholds. The lessee will need to obtain permission from the freeholder for any major changes to the buildings/site. The leasehold agreement may feature a number of restrictions with no guarantee that the lessee can renew the lease.

Leasehold – ownership for 'x' period of time

The various ownership methods across Europe are detailed in Figure 8.

The property purchase process

The commercial property market has tended to be decentralised, inefficient and dependent on the interpersonal skills of buyers and sellers operating in the complex market web of telephone, email and networking.

Auctions aside, there is no public market for commercial property investments. It is primarily a private market, made principally by agents who seek to match buyers and sellers with buildings.

No public market for commercial property investment (exc. Auctions)

Sellers typically engage an agent to market their property. The buyer will usually recognise the agent's role in introducing the property to them, either by retaining the agent to act on the purchase or simply by paying an introductory fee.

There has been a growing trend, especially among larger property investors, to seek off-market transactions, where deals are completed without agents. These off-market deals are likely to continue as sellers aim to reduce sale costs.

A growing trend towards off market transactions

In normal markets, the purchase transaction takes several months from initial marketing to completion (in the UK). During recessionary periods (e.g. the early '90s and the '70s), the number of transactions effectively stalled, whereas in 'hot' markets, the transaction can take a short time to complete.

The differences across Europe are shown in Figure 8.

Figure 6: The purchase process

Source: Credit Suisse research

Transaction costs in the UK

The costs of buying a property are significant when compared with acquiring interests in other assets. In large part, they stem from the fees associated with the necessary due diligence. The market norm is 1.7625%, which reflects fees plus Value Added Tax for the following services:

- agents' advice on the purchase, which may sometimes, but not always, include fees for valuation, building surveys, environmental audits and mechanical and engineering tests; and
- legal transaction fees.

In addition to these costs, buyers must pay Stamp Duty Land Tax on commercial property transactions. The current SDLT rate is 4% where the price is over £500,000. The majority of commercial property traded tends to fall into the 4% bracket.

As the majority of property transactions tend to be above £0.5m, a total transaction cost of 5.7625% is the usual total cost applied for property transactions.

Figure 7: Property transaction costs

Costs	%
Stamp duty	4.0%
Agents fee on purchase	1.0%
Legal fees on purchase	0.50%
VAT on fees at 17.5%	0.26%
Total	**5.76%**

Source: Credit Suisse estimates

Property auction houses also sell commercial lots for sellers. Over the past seven years, the auction market has grown steadily, driven by the growing demand from private investors. The average lot sizes for these assets tend be c.£700k.

The purchase price made between both parties will depend on the valuation process, which we discuss in greater detail in the valuation section of this report.

The purchase costs for direct real estate are provided in Figure 8.

Figure 8: European property purchase methods

	Austria	Belgium	Denmark	Finland	France	Germany	Greece	Ireland	
Common land titles	Freehold	Freehold or leasehold	Freehold	Freehold or leasehold	Freehold	Freehold	Freehold	Mainly freehold or equivalent	
Restrictions' on foreign ownership rights	No restrictions on commercial properties in general; some restrictions on residential and land	No restrictions	Subject to approval by Ministry of Internal affairs (usually a formality)	No restrictions	No restrictions	No restrictions	No restrictions	No restrictions	
Strata title (partial ownership of the building)	Possible	Relatively common	Relatively common	Relatively common	Common through a system of co-propriété	Possible	Very common	Relatively common, through co-ownership, separate freeholds or special purpose company	
Security deposit	Not applicable	10% of purchase price	Usually 10% of purchase price	Varies by transaction	Usually 10% of purchase price	Not applicable	5-10% of purchase price	10% of purchase price	
Responsibility for stamp duty	Purchaser responsible (1% registration fee and 3.5% ground tax)	Purchaser responsible (10% in Flanders and 12.5% in Wallonia and Brussels)	Purchaser usually responsible, sometimes split 50/50 with seller (0.6% of purchase price)	Purchaser responsible (1.6% for real estate company or mutual real estate company, and 4% for purchasing direct property)	Purchaser responsible (6.2% if the building is not under VAT regime, otherwise 1.5%)	Purchaser responsible (3.5% of purchase price, except 4.5% in Berlin, in addition to registry and notary cost)	Not applicable	Purchaser responsible (generally 9% of purchase price; however, company sales can be taxed at a reduced rate)	

	Italy	Luxembourg	Netherlands	Norway	Portugal	Spain	Sweden	Switzerland	United Kingdom
Common land titles	Freehold or leasehold	Freehold or leasehold	Freehold or leasehold perpetual leasehold or limited leasehold (common practice 50 years)	Freehold	Freehold or limited leasehold (40 years)	Freehold	Freehold or leasehold	Freehold or, if industrial, leasehold	Freehold or long leasehold (99-999 year leases)
Restrictions on foreign ownership rights	No restrictions	No restrictions	No restrictions	No restrictions	No restrictions	No restrictions	No restrictions	No restrictions on commercial property, some restrictions apply to residential	Broadly no restrictions but some may not be allowed to invest for political reasons
Strata title (partial ownership of the building)	Possible	Possible	Relatively common	Possible	Relatively common	Possible, but inscription in the Public Registry and Community Rules required	Possible	Possible, but depends on property (PPE – proprieté par etage)	Relatively common
Security deposit	0-5% of purchase price	10% of purchase price	Varies by transaction	Very rare	Varies by transaction	10% of purchase price	Varies by transaction	Varies by transaction	Varies by transaction
Responsibility for stamp duty	Purchaser responsible (2-4% of purchase price)	Purchaser responsible (10% of purchase price in CBD and 7% in periphery)	Purchaser responsible (6% of purchase price)	Purchaser responsible (2.5% of purchase price; however, not applicable if property held by special purpose company)	Purchaser responsible (6% of purchase price for SISA stamp duty and an additional 0.8% of purchase price for stamp duty tax)	Purchaser responsible (7% transfer tax on purchase price)	Purchaser responsible (3% of purchase price; however, not applicable if property held by special purpose company)	Purchaser responsible sometimes split with seller (amount depends on canton)	Purchaser generally responsible (amount depends on transaction size)

Source: JonesLangLaSalle

Rent

What is rent?

Rent is the amount paid by a tenant to a landlord under a legal agreement made by both parties (known as a lease).

Rent: Income earned from property by the landlord

How rent is calculated and assessed varies across Europe. Each country has different lease length standards, review processes and taxes that may need to be considered.

Why assess rental value?

Rental value is assessed for the following purposes:

- to grant a new lease;
- rent review under an existing lease;
- lease renewal; and
- assessment of market rent to assess the value of an investment.

Market rent

Market rent is defined by the International Valuations Standards Committee (ISVC) as:

Some properties may be under-rented (a rent below the market rent) or over-rented (a rent above the market rent)

"The estimated amount for which a property or space within a property, should lease (let) on the date of valuation between a willing lessor and a willing lessee on appropriate lease terms in an arm's-length transaction after property marketing wherein the parties had acted knowledgeably, prudently and without compulsion."

Rent reviews (UK)

Rent reviews are negotiated between the tenant and landlord in the UK

The rent review period is negotiated by the tenant and landlord based on the terms agreed upon in the lease. This varies across Europe; however, in the UK the majority of commercial leases are reviewed every five years. Even though lease terms have reduced over the last 15 years, the rent review process has remained relatively static at every five years.

The majority of leases in the UK are upward-only, meaning at review, rents can only go up or stay at the same rate, even if the estimated market rent has decreased over the period.

Rent reviews are negotiated between the landlord and tenant and are generally based on local market rents. The rent is agreed until the next rent review in the UK. If the landlord and tenant cannot agree on a rent, an arbitrator can negotiate terms between the two parties.

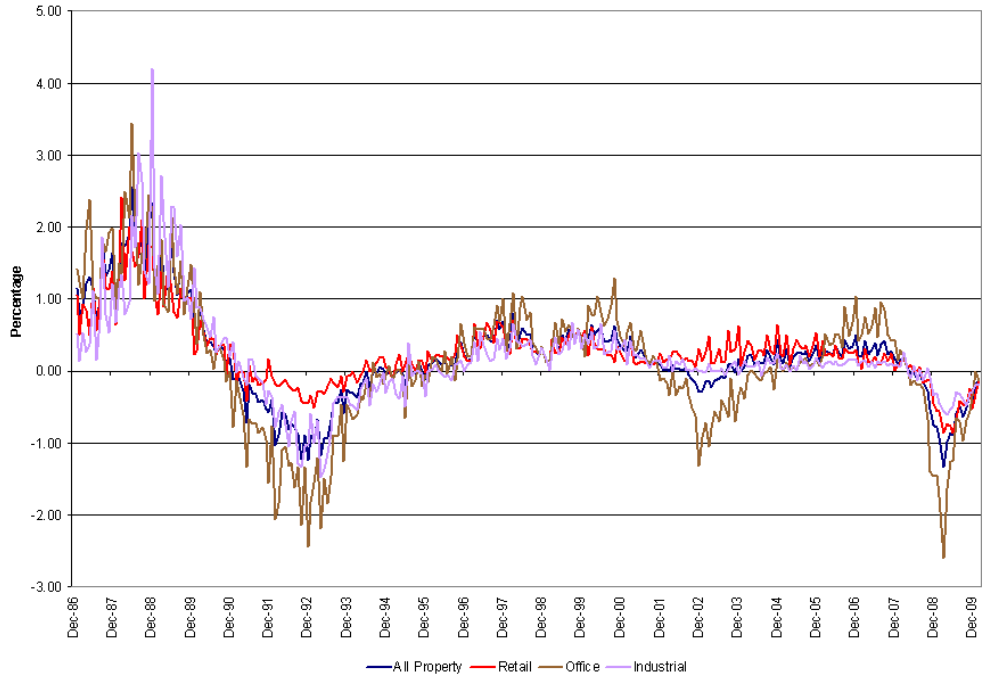
Some lease agreements are linked to inflation/CPI

Leases can be adjusted depending on the agreement determined by the landlord and tenant. For example, instead of upward-only rental agreements, many leases may be linked to an index such as the consumer price index, common across many European marketplaces.

Rental growth

Rental growth is the rate of growth, over a specified period, of the estimated rental value of a property. Rental growth can vary between the property sub-sectors. IPD tracks rental growth across the retail, office and industrial sectors. We note in Figure 8, rental growth can be turbulent at times, with high levels of cyclicality in the office market; however, this is partly due to the weightings' reliance on the City office market.

Figure 9: Nominal Rental Growth (from 1986 to February 2010)



Source: IPD

Rental deposits

Similar to residential leases, a commercial property landlord will hold an amount (the deposit) equal to 3–6 months' rent (varies between lease/country) as a guarantee against any defaults/non-payment in the future. This is common across all countries.

We highlight the differences between European leases in Figure 10.

Figure 10: Pan European Rental Guide

	Austria	Belgium	Denmark	Finland	France	Germany	Greece	Ireland
Units of measurement	Square Metres	Square Metres	Square Metres	Square Metres	Square Metres	Square Metres	Square Metres	Square Metres
Rents	Quoted in €/sqm/month	Quoted in €/sqm/year	Quoted in DKK/sqm/year	Quoted in €/sqm/month (gross rent)	Quoted in €/sqm/year	Quoted in €/sqm/month	Quoted in €/sqm/month	Quoted in €/sqm/month
Typical lease term	Unlimited, 3, 5 or 10 years	9 years with mutual break options every 3 years	5-10 years	3-5 years	9 years with tenant only break options every 3 years	5-10 years	12 + 4 years	25 years with a tenant only break option between years 10-15
Frequency of rental payments (in advance)	Monthly	Quarterly	Monthly / Quarterly	Monthly	Quarterly	Monthly	Monthly	Quarterly
Typical rent deposit/guarantee (expressed as X months net rent)	3 months	6 months (gross rent)	6 months	3 months	3 months	3-6 months	1-2 months	None with sufficient covenant
Does tenant have statutory rights to renew	Yes (buildings before 1951), No (new buildings or leases after 2001)	No – unless negotiated for in original lease	Lease is automatically prolonged until terminated by either of the parties	No – unless negotiated for in original lease	Yes – subject to a new market rent	No – unless negotiated for in original lease	No – leases are for 12 years with automatic right to renew for another 4 years (12 + 4), after this, no statutory right to renew	Yes - after 5 years, unless specified otherwise in original lease
Basis of rent increases or rent review	Consumer Price Index	Health Index (Modified Cost of Living Index)	Net Price Index Additional opportunity for adjustment to market rent	Cost of Living Index	ILC or ICC. ILC is made up of 50% CPI, 25% ICC and 25% retail turnover index.	Consumer Price Index	Consumer Price Index plus one or two percentage points	Open market rental value
Frequency of rental increases or rent review	Annual indexation	Annual indexation	Annual indexation	Annual or biannual indexation	Annual indexation	Annual indexation	Annual indexation	5 yearly upward only rent review

	Italy	Luxembourg	Netherlands	Norway	Portugal	Spain	Sweden	Switzerland	United Kingdom
Units of measurement	Square Metres	Square Metres	Square Metres	Square Metres	Square Metres	Square Metres	Square Metres	Square Metres	Square Feet
Rents	Quoted in €/sqm/year	Quoted in €/sqm/month	Quoted in €/sqm/year	Quoted in NOK/sqm/year	Quoted in €/sqm/month	Quoted in €/sqm/month	Quoted in SEK/sqm/year	Quoted in CHF/sqm/year	Quoted in £/sqft/year
Typical lease term	6 + 6 years	9 years with tenant only break options every 3 or 5 years	5 years (existing building) or 10 years (new building)	5-10 years	5 years	5 years	3-5 years	5 years for office plus options, 10 years for retail	10-15 years
Frequency of rental payments (in advance)	Quarterly	Monthly / Quarterly	Monthly / Quarterly	Quarterly	Monthly	Monthly	Quarterly	Monthly / Quarterly	Quarterly
Typical rent deposit/guarantee (expressed as X months net rent)	3 months	3-6 months (gross rent)	3 months (gross rent)	6-12 months	2 months	2 months	Usually 6 months bank guarantee (net or gross rent)	3-12 months	3 months when covenant is unsuitable, but generally varies greatly, and depends on the covenant strength of the tenant
Does tenant have statutory rights to renew	Yes – after first six years; after second six years no right to renew, however, landlord can break the lease at the end of the first six years if the building will undergo a complete refurbishment or if he will use the space by himself	No – unless negotiated for in original lease	No	No – unless negotiated for in original lease	No – unless negotiated for in original lease	No – unless negotiated for in original lease	Yes, subject to terms and conditions set by the Swedish rental tribunal	No – unless negotiated for in original lease	Yes – but can be excluded by agreement between the parties (No statutory right to renew in Scotland)
Basis of rent increases or rent review	0.75% of ISTAT annual inflation rate	Cost of Living Index	Consumer Price Index (market reviews if agreed)	Annual inflation	Consumer Price Index	Consumer Price Index – unless otherwise negotiated	Consumer Price Index	Consumer Price Index	Open market rental value
Frequency of rental increases or rent review	Annual indexation (or rent review after important refurbishment works)	Annual indexation	Annual indexation	Annual indexation	Annual indexation	Annual indexation	Annual indexation	Annual indexation	5 yearly upward only rent review

Source: JonesLangLaSalle

Leases

A lease is a legal written agreement between a landlord (e.g. British Land) and the lessee/tenant (e.g. Bank of Tokyo). The lessee will compensate the landlord by paying rent for using the property for a specified period. A lease can have a significant impact on the value of a property. As discussed earlier, a covenant can affect the value of your property.

Lease: written agreement between the landlord and the tenant.

The lease will include details of the:

- rent amount;
- term of the lease (and whether any break options exist);
- any additional costs that need to be considered, such as 'service charges';
- rent reviews;
- sub-leasing (a property is re-leased by the current tenant; ultimate responsibility remains with the original tenant and the landlord's permission is required);
- Landlords/tenants may agree to a number of specific terms

A typical lease in the UK is now, on average, 10–15 years, containing full repairing and insuring terms and five-yearly upward-only rent reviews. The upward-only rent reviews provide a floor to the rent passing such that rent can not fall below. This floor provides a bond-type characteristic, but with the potential upside at each rent review.

Leases in the UK are distinctly different to those in continental Europe. We evaluate these in the following pages.

Lease lengths

In the UK, lease lengths have gradually reduced over time. Pre-WWII, it was common to witness lease terms in excess of 60 years, with only one rent review in between. Lease lengths started to shorten post WWII and have continued to do so ever since.

The average lease length in the UK is now c.10 years.

Even the typical institutional lease length of 25 years is considered a long period compared with current trends and our European counterparts. Long leases have provided difficulties for some landlords, such as shopping centre operators, who wish to refurbish and rejuvenate a property more regularly.

Indexation versus open market value

As can be seen in the rental guide in Figure 10, rental increases during the lease term are usually linked to an index, e.g. CPI, or against current open market value. Rent review periods can vary significantly by country.

Figure 11: Lease lengths across Europe

Austria	5-15 years
Belgium	Minimum of 9 years. Tenant break every 3 years.
Czech Republic	5-15 years
Denmark	5-10 years
Estonia	No established rules. Depends on many factors, such as type of building and premises, specific Tenant, potential upsides or risks expected in the market, etc. Prime properties 3-5 minimum, up to 10 years. Less in secondary locations.
Finland	3-5-10 years
France	Traditionally 9 years in accordance with the 1953 decree. Tenant break options every 3 years. New leases for shopping centres tend to be for 10 years and 12 years for prime high street locations, with 3 yearly tenant break options
Germany	10 years, with option for further 5 years. Or 5 years with option for further 5 years.
Greece	6-12 years
Hungary	Normally 3-5 years on the high street. 10 years in shopping centres.
Ireland	20-25 years, breaks uncommon.
Italy	6 years
Kazakhstan	7-10 years
Latvia	5-10 years, 10-15 years for anchor tenants.
Lithuania	5-10 years, preference - 10 years.
Netherlands	5-10 years
Poland	5-10 years, but can have an option to extend.
Portugal	6-10 years
Romania	5-20 years
Russia	3-5 years 10 years for anchor tenants.
Spain	For Shopping Centres, 5-10 year. For retail warehousing or anchors (retail and leisure) the length lease could be 3 to 15 or some times 20 years.
Sweden	3-5 years
Turkey	5 years 10 years for anchor tenants.
Ukraine	3-5 years 10 years for anchor tenants.
UK	25 years traditionally, but down to 10 years is now common.

Source: Jones Lang LaSalle

Break options

The break option provides the landlord or tenant the option of ending the lease before the end of the lease term. It is now increasingly common to see break clauses in leases. Notice generally has to be provided and the majority of landlords prefer to avoid a break as it can negatively affect the valuation of the property. It is normally assumed when evaluating a property that the tenant will exercise the lease break option.

The average break option for a UK lease is c.5 years; however, breaks tend to be at more regular internals in continental European leases.

Even though a break clause can be considered a negative for a landlord owing to potential loss of income and the inconvenience of finding another tenant; this also provides an opportunity for the landlord to make improvements, in turn potentially increasing the estimated rental value of a property.

For example, a shopping centre owner could use the break clause as an opportunity to improve the retail mix of its centre in line with the centre's strategy. Landlords could also use the break to re-let the space to a better tenant or to refurbish the space to provide a wider range of uses (e.g. food).

Tenant inducements

- Rent-free periods

Inducements are commonplace in the industry and increase during a downturn and decrease during an upturn in the market

Rent-free periods are commonly included in leases for new retail and office space. A rent free period simply refers to a period of time wherein no rent is payable by the tenant. The length of rent-free periods depends on a number of factors.

For example, in London's City office market, if there are several new office developments in the marketplace with only a small number of space requirements, a landlord is likely to extend the level of the rent-free period to fill the space.

- Capital inducements

A capital inducement is sometimes paid by the landlord to assist with fitting out costs; however, it can also simply be used to entice a tenant to take space.

Headline rent

The headline rent is the open market rent paid excluding any inducements or incentives. The headline rent is the amount paid post the expiration of any inducements. Companies tend to declare headline rents as they show a slightly more positive picture.

Net effective rent

The effective rent is the open market rent taking into account any inducement a tenant may have received, such as a rent-free period. When comparing rents between different leases, most property companies will usually provide the headline rent (the rent which does not take into account inducements). For this reason, to really know the current market rent, a grasp of current incentives and the net effective rent is important—especially in the office market, where such incentives are more common.

The effective rent is the open market rent taking into account any inducement a tenant may have received, such as a rent free period.

The net effective rent provides a single measure taking into account the various inducements and is quoted on per sq/foot or metre basis.

Figure 12: Example – Net effective rent

If 5,000 sq.ft of office space normally rents for £60 per sq.ft pa,
but the landlord gives 2 years rent free on a 10 year lease, then
the net effective rent is calculated as follows:

5,000 sq.ft x £60 = £300,000
2 years rent free = £0
8 years paid rent @ £300,000 = £2,400,000
£2,400,000 paid rent spread over a 10 year term = £240,000 pa effective rent
£240,000 effective rent / 5,000 sq.ft = £48 per sq.ft pa.

Source: Credit Suisse estimates

Key money/Lease premium

A lease premium, or key money (as it is commonly known in Europe), is a payment made from a prospective lessee for a leasehold interest. The lease premium is the price paid for the purchase of (usually) a leasehold interest representing a capital payment to reflect that the rent payable is below market value or, alternatively, to recognise a special value to the purchaser above market value.

Establishing rental value

The main methods used for assessing rental value are:

- comparable transactions (the most common method); and
- trading potential method.

Trading potential method

- This method is conventionally used for trading properties such as hotel and leisure properties and where comparable rent evidence is rare.
- Rental value is assessed in relation to current turnover (or, to be precise, 'fair maintainable trade').

Where rent is based in relation to trading potential; this is known as a **turnover lease**. These leases are rare in the UK, but commonplace in the European and US markets.

Turnover leases

Turnover leases tend to combine a base rent which is c.70–80% of the current estimated rental value and subject to periodic rent reviews, plus a turnover rent expressed as a percentage of the verified turnover. These leases allow landlords to assess the performance of their tenants and aid those that may be going through trading difficulties.

Turnover leases: rare in the UK, but common in the US and Europe

Comparable transactions – the most common method

Establishing rental value through the comparison of local market transactions is the most common method used by valuers for ascertaining the current market rental value for a property.

Determining rental value can be a difficult task, even in an active market, as each property is distinctly different. Using comparable evidence; the valuer will need to consider some of the following items:

Figure 13: Items to consider when evaluating comparable property rental data

Comparable property	Quality of (comparable) evidence
Size and configuration	Recent
Quality and type of accommodation	Relevant
Condition	Accurate
Location	Capable of analysis
Covenants of the lease	

Source: Credit Suisse research

Sources of comparable information

There is no set rules for calculating rental value; however, valuers will use a multitude of methods to reach an estimated value

Sources of comparable information include Estates Gazette, Focus and the Land Registry for leases beyond six years. These databanks provide an indication of potential rental values, but are by no means comprehensive.

A valuer may also consider reviewing recent lease renewals and rent review settlements for evidence; however, these may not necessarily provide a true reflection of the current market rent. For example, at a lease renewal, a landlord may be happy to continue with a current tenant and charge just below market rent as a reward for loyalty.

Units of comparison of calculating rental value

Where a comparable property is not available, it is often the case that a valuer will use a unit of comparison to find the full rental value of the property.

Figure 14: Unit of comparison

Property type	Imperial	Metric
Industrial	Per square foot	Per metre^2
Office	Per square foot	Per metre^2
Retail	Per square foot	Per metre^2

Source: Company data, Credit Suisse estimates

By using ‘units of comparison’, properties of varying sizes are reduced to a common unit of area, making it possible to compare them (e.g. retail and office space are commonly compared using ‘per sq ft’ measurements).

Figure 15: Example – Rental values

A single storey shop with a frontage of 6m and a depth of 13m has to be let.
What rent is it likely to command if a near-by single-storey shop with a frontage of 5m and a depth of 13m was recently let for £10,000pa?

Analysis of recent letting		
5 x 13 @ £10,000pa	=	65 m2 @ £10,000
	=	£153.8462 / m^2
Rent assessment		
6m x 13m @ £153.8462 / m^2	=	Estimated rental value
		£12,000 pa

Source: An introduction to property valuation

The actual assessment of rent is an important process, as any discrepancy at this stage could have a significant impact on the capital value of the property. We discuss this in greater detail in the 'valuation' chapter.

Zoning

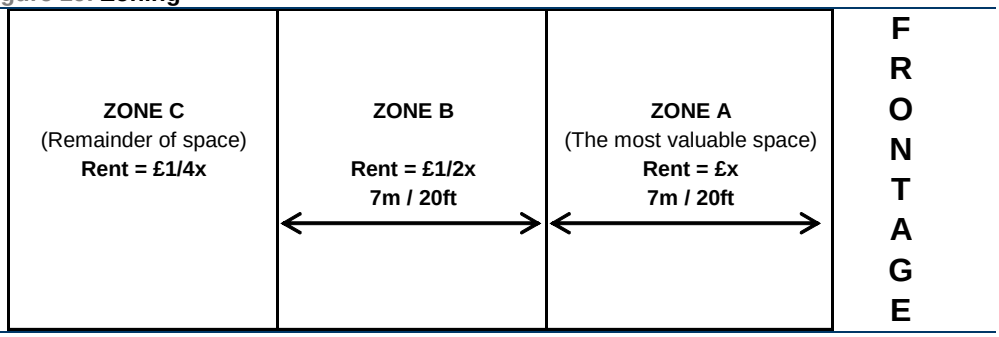
Zoning is a method of analysing the rental value of retail space (usually on the ground floor) by dividing the floor into strips parallel with the main frontage. A different value per unit of space is attributed within each strip corresponding to its relative ability to achieve sales/profit. The most valuable space is normally towards the front and is known as 'Zone A'. All other strips are valued 'in terms of Zone A'

Zoning is a UK-specific method for calculating rental value for use in prime high street and shopping centres

The basic premise of Zoning is that space at the front of a retail unit is more valuable than space at the back of the unit. For large retail stores and retail warehouses, a rent on a per sq.ft/metre basis is applied.

For example, notice that the fragrance department is always at the entrance of a department store – fragrances are some of the most profitable products!

Figure 16: Zoning



Source: Real Estate appraisal

Zones are often calculated at 20ft depths and it is rare to have more than three zones. Rental values using the zoning technique find that values are 'halved back' at each zone. For example, Zone A at £X/m^2, Zone B at £0.5X/m^2 and Zone C at £0.25X/m^2. Zone C is the remainder of the retail space, which includes the basement and upper floor retail space.

Figure 17: Example – Zone A rents per sq.ft

Shopping centres	**Zone A rents**
Lakeside, Thurrock	£363
Manchester Arndale	£300
Eldon Square, Newcastle	£330
Prime London shopping streets	
Oxford St (West)	£530
Old Bond Street	£700
James Street, Covent Garden	£570

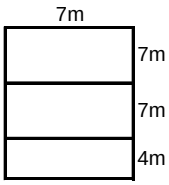
Source: Company data, Knight Frank, King Sturge

Fact: the most expensive retail space in the UK is London's Bond Street, at £800 ITZA.

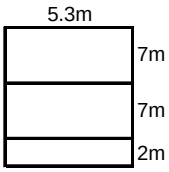
Figure 18: Example – Zoning in action

72, High Street, a shop with 7m frontage and 18m depth, was recently let for £16,500 pa. The rental value of 68, High Street, which has a frontage of 5.3m and a depth of 16m, is required.

72 High Street
£16,500 pa



68 High Street



Analysis of 72, High Street	
Zone A = 7m x 7m @ £X/m2 =	49X
Zone B = 7m x 7m @£0.5X/m2 =	24.5X
Zone C = 7m x 4m @ £0.25X/m2 =	7X
Total rental value £16,500 pa	**80.5X**

£204.97 = X	
The value /m2 of Zone A =	£204.97
The value of /m2 of Zone B =	£102.48
The value /m2 of Zone C =	£51.24

Valuation of 68, High Street
Assuming the property is a true comparable

Zone A = 5.3m x 7m @204.97 =	7,604.39
Zone B = 5.3m x 7m @ £102.48 =	3,802.01
Zone C = 5.3m x 2m @ £51.24 =	543.14
Full Rental Value =	**£11,949.54**

Source: Introduction to Property Valuation

Property outgoings

The gross rental value is often adjusted for property outgoing and associated costs resulting in a net rental value.

Outgoings include repairs, insurance premiums, general rates, water rates, and management costs. Some of these outgoings are paid by the tenant, although this is dependent on what is outlined in the lease, which should clearly state which party is responsible. Internal repairs tend to be paid for by the tenant in the majority of cases.

Landlords/Property companies will generally set aside a contingency to take into account any repairs or general outgoings where the tenant cannot actually afford to. This is rare, but can happen—especially where the landlord has a large portfolio.

The cost of insurance against fire and similar risks will be related to the cost of constructing a similar building, hence the valuer will be valuing the cost to re-build. The premium charged will be considered an outgoing by the property company; however, it is often charged back to the tenant through a service charge (this is discussed in greater detail in Figure 20).

Rates, both general and water and any other similar charges are normally the liability of an occupier and will not often have to be paid by a landlord.

Management expenses will occur with all properties, from checking that the tenants are complying with all their obligations to managing rent collection, cost of their time etc. Most property companies will have dedicated property managers to ensure the property is operationally performing.

Figure 19: European property outgoings

	Austria	Belgium	Denmark	Finland	France	Germany	Greece	Ireland
Responsibility for service charge/ management fees	Tenant responsible for his pro-rata share in addition to the rent – payable monthly based on estimates and reconciled once per year	Tenant responsible for his pro-rata share in addition to the rent – payable quarterly based on estimates and reconciled once per year	Tenant responsible for his pro-rata share in addition to the rent – payable quarterly / monthly based on estimates and reconciled once per year	Tenant responsible for his pro-rata share, but included in the rent – payable monthly based on estimate and reconciled once per year	Tenant responsible for his pro-rata share in addition to the rent – payable quarterly based on estimates and reconciled once per year	Tenant responsible for his pro-rata share in addition to the rent – payable monthly based on estimates and reconciled once per year	Tenant responsible for his pro-rata share in addition to the rent – payable monthly based on actual usage	Tenant responsible for his pro-rata share in addition to the rent – payable quarterly based on estimates and reconciled once per year
Responsibility for utilities	Electricity, water and telecommunication consumption are separately metered and payable by each tenant	Electricity and telecommunication consumption are separately metered and payable by each tenant; water consumption is included in the service charge	Electricity, heating and telecommunication consumption are separately metered and payable by each tenant; water consumption sometimes measured separately, otherwise included in the service charge	Electricity and telecommunication consumption are separately metered and payable by each tenant; water consumption included in service charge	Electricity and telecommunication consumption are separately metered and payable by each tenant; water consumption is included in the service charge	Electricity and telecommunication consumption are separately metered and payable by each tenant; water consumption is included in the service charge	Electricity, water, natural gas and telecommunication consumption are separately metered and payable by each tenant	Electricity and telecommunication consumption are separately metered and payable by each tenant water consumption included public taxes
Responsibility for internal repairs	Tenant responsible within the private leased area	Tenant responsible within the private leased area	Tenant responsible within the private leased area	Tenant responsible within the private leased area	Tenant responsible within the private leased area	Tenant responsible within the private leased area	Tenant responsible within the private leased area	Tenant responsible within the private leased area
Responsibility for repairs of common parts (reception, lifts, stairs, etc)	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible but often costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible for standard maintenance only, costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge
Responsibility for external/structural repairs	Landlord responsible	Landlord responsible with possible charge back to tenant via service charge unless structural	Landlord responsible	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible	Landlord responsible	Landlord responsible but costs charged back to tenant via service charge
Responsibility for building insurance	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible but often costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible in multi-tenant building; tenants responsible in single-tenant building	Landlord responsible but costs charged back to tenant via service charge

Source: Jones Lang LaSalle

Figure 20: European property outgoings

	Italy	Luxembourg	Netherlands	Norway	Portugal	Spain	Sweden	Switzerland	United Kingdom
Responsibility for service charge/ management fees	Tenant responsible for his pro-rata share in addition to the rent – payable bimonthly based on actual usage	Tenant responsible for his pro-rata share in addition to the rent – payable monthly / quarterly based on estimates and reconciled once per year	Tenant responsible for his pro-rata share in addition to the rent – payable quarterly / monthly based on estimates and reconciled once per year Management fees payable monthly / quarterly as a percentage of the service charge (5%)	Tenant responsible for his pro-rata share in addition to the rent – payable quarterly either based on actual usage or on estimates and reconciled once per year	Tenant responsible for his pro-rata share in addition to the rent – payable monthly based on estimates and reconciled once per year	Tenant responsible for his pro-rata share in addition to the rent - payable monthly based on estimates and reconciled once per year	Tenant responsible and pro-rata share included in the rent	Tenant responsible for his pro-rata share in addition to the rent – fixed amount as negotiated in the lease payable quarterly / monthly	Tenant responsible for his pro-rata share in addition to the rent – payable quarterly based on estimates and reconciled once per year
Responsibility for utilities	Electricity and telecommunication consumption are separately metered and payable by each tenant; water consumption is included in the service charge	Electricity and telecommunication consumption are separately metered and payable by each tenant; water consumption is included in the service charge	Electricity, water and telecommunication consumption are usually separately metered and payable by each tenant	Electricity and telecommunication consumption are separately metered and payable by each tenant	Electricity, water and telecommunication consumption are separately metered and payable by each tenant	Electricity, water and telecommunication consumption are separately metered and payable by each tenant	Electricity and telecommunication consumption are separately metered and payable by each tenant; water consumption is either included in the service charge or metered separately and payable by each tenant	Electricity and telecommunication consumption are separately metered and payable by each tenant; water consumption is included in the service charge	Telecommunication is separately metered and payable by each tenant; water and heating consumption included in the service charge; electricity varies: normally metres on each floor determine usage, but is occasionally covered by service charge
Responsibility for internal repairs	Tenant responsible within the private leased area	Tenant responsible within the private leased area	Tenant responsible within the private leased area	Tenant responsible within the private leased area	Tenant responsible within the private leased area	Tenant responsible within the private leased area	Tenant responsible within the private leased area	Tenant responsible within the private leased area sometimes with the participation of the landlord	Tenant responsible within the private leased area
Responsibility for repairs of common parts (reception, lifts, stairs, etc)	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible but some of the costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible	Dependant on what had been negotiated in the lease contract	Landlord responsible but costs charged back to tenant via service charge
Responsibility for external/structural repairs	Landlord responsible but costs charged back to tenant via an extraordinary maintenance charge when required	Landlord responsible	Landlord responsible	Landlord responsible	Landlord responsible	Landlord responsible	Landlord responsible	Landlord responsible	Landlord responsible but costs charged back to tenant via service charge
Responsibility for building insurance	Landlord responsible	Landlord responsible but costs charged back to tenant via service charge	Landlord responsible	Landlord responsible	Landlord responsible with possible charge back to tenant via service charge	Landlord responsible	Landlord responsible	Landlord responsible but costs charged back to tenant via service charge (with exception of cantonal fire insurance)	Landlord responsible but costs charged back to tenant (separate from service charge)

Source: Jones Lang LaSalle

Service charges

A service charge is an amount payable by a tenant for services provided by the landlord. Differences exist for service charges across European markets, which are detailed in Figure 21. More often than not, the tenant is responsible for most of the property costs while in occupation.

A service charge is an amount payable by a tenant for services provided by the landlord.

Service charges are generally ‘Not for profit, not for loss’; where the costs of providing the services to a property are recovered from the users of those services. The total costs recovered will not be inflated for profit. Similarly, there should not be a residual loss left for the owner to pay.

Service charges enable the sharing of costs of common services in properties between more than one occupier. There will be a manager who administers these services (for which he or she will receive a fee). These management fees will be transparent with no hidden markups.

Service charges are apportioned across occupiers; the split could be by floor area, fixed percentage, rateable value or simply a fair and reasonable proportion. This would be outlined in an ‘apportionment matrix’, which would then be provided to tenants.

In the UK, the RICS have produced a code of practice for service charges in commercial property that embody ‘best practice’.

What fees are included within a service charge?

This can vary considerably, but Figure 21 shows a list of some of the many charges.

Figure 21: Service charges

Management	
Management fees	Managing agent fees
Accounting fees	Auditor fees
Site management resources	Staff, Receptionists, Site accommodation, Petty cash
Health & Safety	Landlord's risk assessments and consultancy audits
Soft Services	
Security	Guarding, Systems
Cleaning and environment	Internal/External, Window, Hygience, Waste management, Pest control, Landscaping
Utilities	**Marketing and promotions**
Electricity	Events
Gas	Marketing
Fuel oil	Research
Water	Staff costs
Energy/Utility procurement	Landlord's contribution to marketing
	Local authority contribution to marketing
Hard services	**Exceptional expenditure**
Mechanical electrical services	One-off project works
Maintenance contracts	Refurbishments
Lift safety and maintenance	Plant replacement
Escalator repairs/inspections	Major repairs
Income	**Insurance**
Car park income	Engineering insurance
Vending machine income	All risk insurance cover
Other	Terrorism insurance
Forward funds	
Sinking funds	Forward funding of specific major replacement projects (e.g. roof replacement)
Reserve funds	Forward funding of specific periodic works to even out fluctuations in annual service charge costs (e.g. internal decorations)
Depreciation charge	Depreciation charge in lieu of sinking/replacement fund contribution of major plant and equipment

Source: Credit Suisse research

Full repairing and insuring leases (UK)

The majority of leases in the UK tend to be let on full repairing and insuring terms, with the tenant responsible for the payment of repair and insurance for the property. This may sometimes be included within the service charge.

Tenants account for all property expenses, from rent to rates, as one large cost base. Therefore, if rates increase, there will be a lesser amount available for rents. This is likely to remain an important point as the cost of utilities and business rates increase.

Tenants look at all property costs – rent, rates, property outgoings – as one cost base

Assigning/Subletting space

If a tenant no longer requires its premises and is not in a position to terminate the lease, the tenant has the choice of either subletting or assigning the property interest to another tenant, assuming the lease allows it and the permission from the landlord is granted.

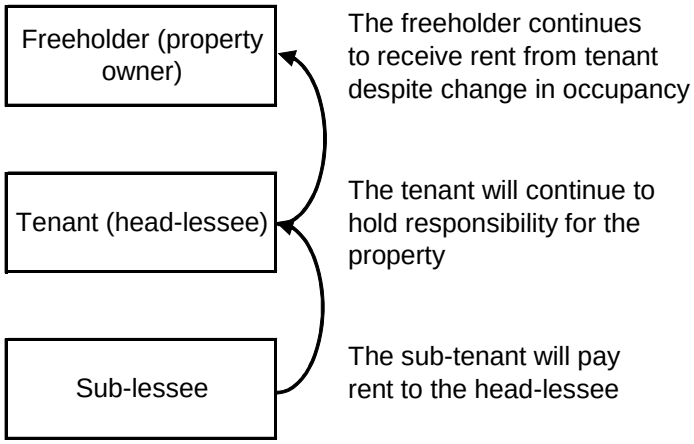
The tenant can sublet the premises by granting a sub-lease to a new occupying tenant for a term of years less than the original lease. In this case, the original tenant is known as the head lessee (or lessor) with the new tenant called a sub-lessee. The sub-lessee will pay a sub-rent to the head lessee who in turn will continue to pay rent, the head rent, to the property owner.

By transferring (assigning) the leasehold interest, the tenant transfers all the rights to the property to the assignee (incoming tenant) for the full remaining term of years. The assignee will then be directly responsible to the landlord (the freeholder). The assignee may pay the assignor a leasehold premium for the property.

The property owner will expect to see little change to income stream during this process.

Most assigned leases will include an authorised guarantee agreement, where the assignor agrees to guarantee the rent if the assignee defaults, thus protecting the landlord's income.

Figure 22: Lease assignment



Source: Credit Suisse estimates

Property sub-sectors

Property has, so far, been categorised as industrial, office or retail sub-sectors. Each sub-sector features a number of further variations with distinctions from lease terms to rental values.

You may be surprised by with how familiar you already are with the property sub-sectors.

The world of property features a number of sub-sectors from prime shopping centres to regional warehousing…we examine the various cases here.

Chapter Definitions:

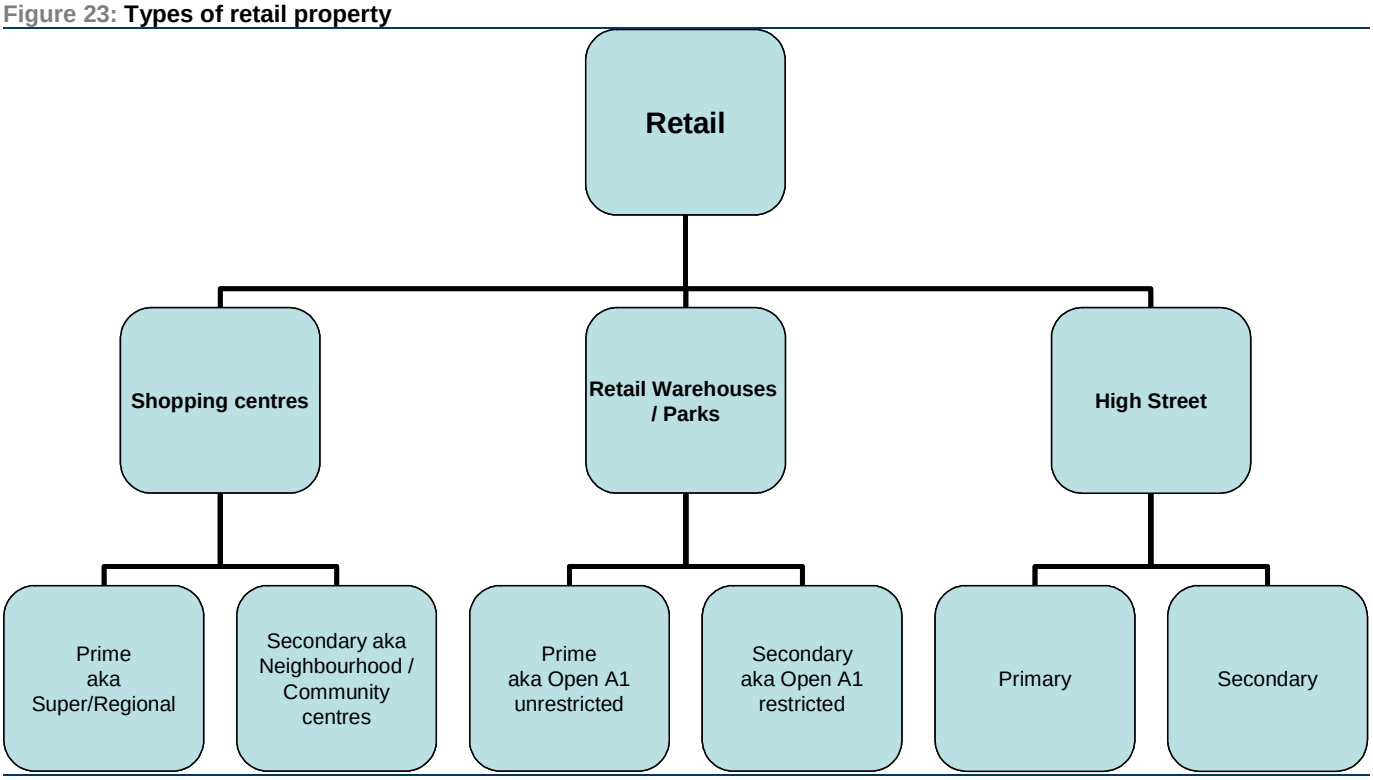
Prime property: Description of an investment that is regarded as best in class, location or sector. A secondary property will not feature all these characteristics.

Prime trading location: A comparative term which may be related to a town or to a shopping centre which has, and can expect to retain, the best quality of tenant and which has the best forecast for rental growth.

Retail

Retail property encompasses a wide array of property sub-sectors—from the local corner shop to your city centre shopping centre to the large super-store at the edge of town.

Figure 23: Types of retail property



Source: Credit Suisse research

Shopping centres

Shopping centres are properties featuring a collection of stores located indoors. Shopping centres are common across Europe. They vary in terms of shape, size and retail offering and the format, which has been around for 40 years, has evolved over time. In the 1970's, a landlord's focus was on renting vacant space to tenants on long leases to ensure the financial viability of the centre. However, this view has changed over the past forty years.

Anchor tenants

Shopping centres will usually have an 'anchor' tenant; these tenants are typically large department stores or supermarkets that attract footfall to the centre and encourage other retailers to sign up to the scheme. The larger the development, the more anchors are required. For example, Westfield London featured four anchors positioned in each corner of the centre (Debenhams, Marks & Spencer, Next and House of Fraser).

It ,ay help to think of shopping centres you have been to/ What were the anchor stores? How would you compare one centre compared to another based on the retailer mix?

Shopping centres have continued to evolve over time

The shopping centre format has evolved as landlords/developers consider a number of factors, such as retail mix, centre visitor profiles, anchors etc. For example, landlords are now closely considering the retail mix they offer in their centres and are increasing leisure facilities, such as cinemas and food offering. The aim for most landlords is creating a one-stop location featuring a number of activities rather than a simple collection of indoor stores.

This evolution can be clearly seen in the case of the Bluewater shopping centre in London. The centre offers a cinema, 13,000 free car parking spaces, over 300 stores from premium to value offerings and a food court offering a selection to satisfy visitors. Shopping centres have gradually grown in size—now ranging from 400,000 sq.ft to 1.8m sq.ft. Westfield London centre is 1.6m sq.ft in size.

In-town / Out-of-town / Prime / Secondary

Although we have split the shopping centre segment into prime and secondary categories, shopping centres can also be 'in town' and 'out of town'.

An in-town centre is located in the city/town centre—examples include Manchester Arndale and Bristol's Cabot Circus. Out-of-town centres are located in arterial locations near popular transport routes, as the majority of visitors are expected to reach them by car. Examples include Meadowhall, Lakeside Thurrock and the Metrocentre in Gatehead.

The difficulties in development

Shopping centre development tends to be left to the specialists rather than to novice developers. Obtaining planning permission for a centre can take several years due to the need to assess local market impact, infrastructure, transportation issues etc. They can also be very expensive to build, with Westfield London costing £1.6bn to construct. Shopping centre valuations can vary, but can exceed £1bn for top-end centres.

With development costs in excess of £1bn, this is a market for specialist players

A reminder on zoning (UK)

Rental values at shopping centres are measured using 'In terms of Zone A', as discussed earlier within this primer. ITZA values rental values can vary significantly depending on the position of the store. The highest rental value will be for prime positioned property (in comparison to secondary).

Zone A rental values – specific to the UK

For example, some centres have found that ground floor units can charge a rent double the upper floors, as footfall is greater on the ground owing to the car park location. Developers are constantly aiming to drive footfall across a centre; they aim to do this through position anchors at either ends/corners and providing leisure facilities in higher locations.

Shopping centre REITs include, Unibail-Rodamco, Liberty International, Hammerson, British Land and Corio.

Figure 24: Shopping centre in the UK

Rank	Shopping centre	Location	Gross Area (m/sq.ft)
1	Bluewater	Dartford - Greenhithe	1.610
2	MetroCentre	Gateshead	1.598
3	Merry Hill Centre	Brierley Hill	1.500
4	Meadowhall	Sheffield	1.453
5	Westfield London	London	1.400
6	Lakeside	Grays - Thurrock	1.377
7	Trafford Centre	Manchester	1.375
8	The Centre: MK	Milton Keynes	1.300
9	Whitgift centre	Croydon	1.236
10	Bullring	Birmingham	1.200

Source: Credit Suisse estimates – this list does not include Westfield London and St David's 2 in Cardiff

Retail Warehouses / Parks

A retail warehouse is a retail store selling non-food goods occupying a warehouse. A retail park is a collection of retail warehouses usually located on arterial routes with sufficient car parking. The number of retail parks across Europe has continued to grow over the past twenty years, but the basic format has remained the same.

Retail parks and warehouses tend to be large units focusing on 'bulky good' occupiers, such as furniture and electrical goods. This ensures that the retail parks do not compete with town centre shops.

Retail parks are located on arterial routes and feature extensive car parking.

Open A1 (UK)

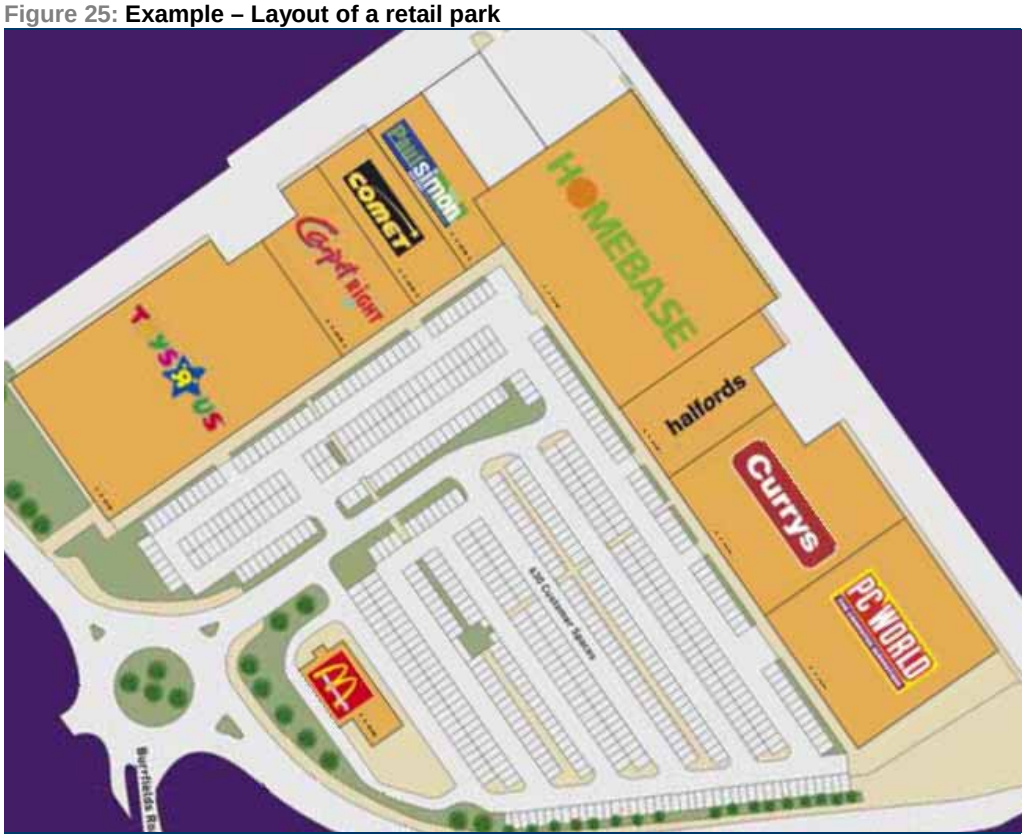
Planning restrictions in the UK mean that retail parks are confined to certain retail sectors. This is to ensure that a retail park does not compete with local high streets.

Open A1 trades include:

- DIY / Builders merchants;
- garden centre foods;
- furniture and carpet stores;
- electrical goods;
- car sales/accessories; and
- retail trading in bulky goods

Local authorities remain committed to restricting retail parks to protect out-of-town trading.

Figure 25: **Example – Layout of a retail park**



Source: Company data, Credit Suisse estimates

High street retail

High street retail consists of a parade of shops located across Europe's towns and villages. High street retail exists in most town centres whether it is a small collection of 5 stores or a wider selection of 100 stores.

Traditional retail offerings followed this format across Europe for hundreds of years until the emergence of new formats such as shopping centres, retail parks etc., post WWII. The high street still remains the heart of many communities, but has clearly been affected by the new wave of retail formats.

High Street shop values tend to be relatively low (e.g. less than £1m) compared with shopping centres and retail parks. They are generally owned by the occupier, private investors and a handful of institutions.

High street retail does not necessarily have to be the village parade of shops; main shopping streets such as Oxford Street in London would also fall into this category.

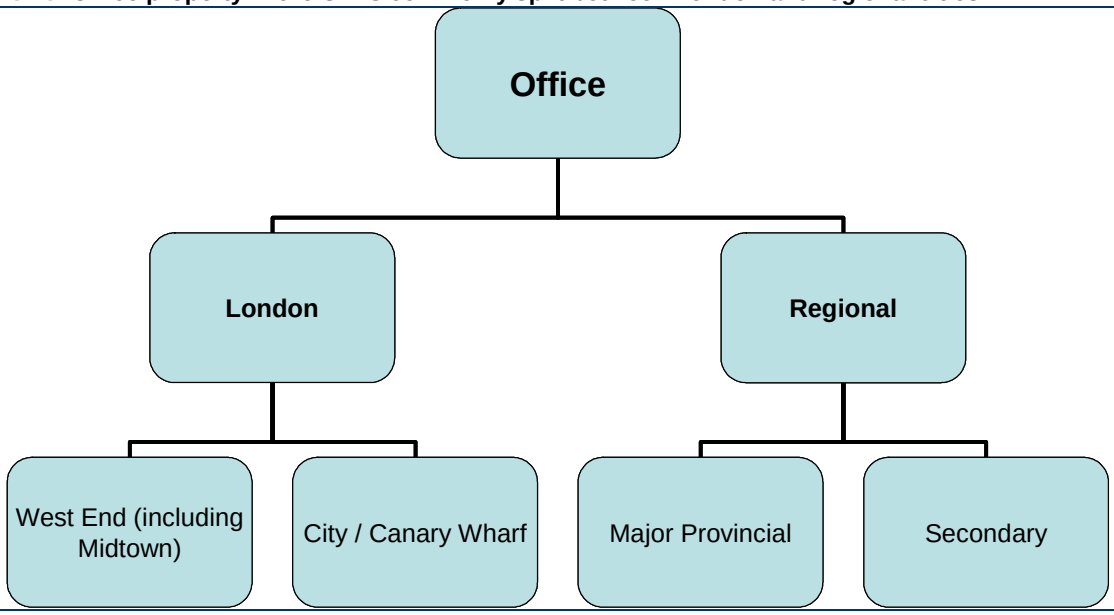
High street retail is held by Liberty International, VastNed Retail, Land Securities, Local Shopping REIT and Corio, for example.

Offices

Office space has continued to grow over the past 40 years, as Western European countries head into service-orientated industries. Offices can vary in size from one room to dedicated office buildings. The types of office property are detailed below and are also split into Grades (e.g., A, B.)

Grade A office buildings will have the highest quality fit and finish and will also be well located, while Grade B assets will be of a slightly poorer quality/location. The rental income between the different grades can vary greatly in mature office markets.

Figure 26: Office property in the UK is commonly split between London and regional cities

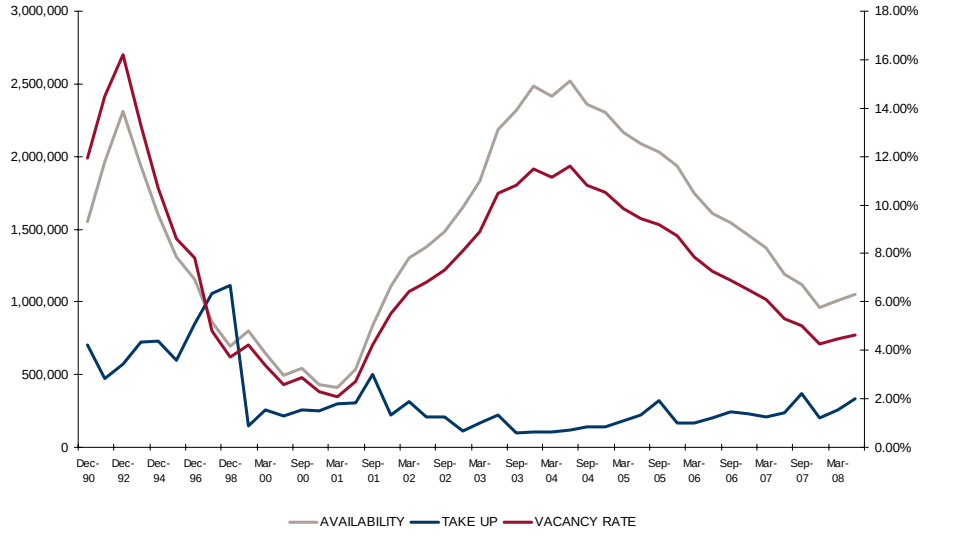


Source: Company data, Credit Suisse estimates

With occupier needs changing over time, office developers have had to ensure that new developments stand the test of time by allowing tenants the flexibility to manage their space as well as considering the impact of technology such as air conditioning, computer cabling, lighting, etc.

The London office market

Figure 27: Central London office availability, take up and vacancy rates



Source: Cushman & Wakefield

Offices within this report are split between City, West End and Regional offices. Each of these markets features varied dynamics for developments and rental income.

The London office market is diverse, offering varying quality across the sector. To simplify, we have split the market in two: West End and City.

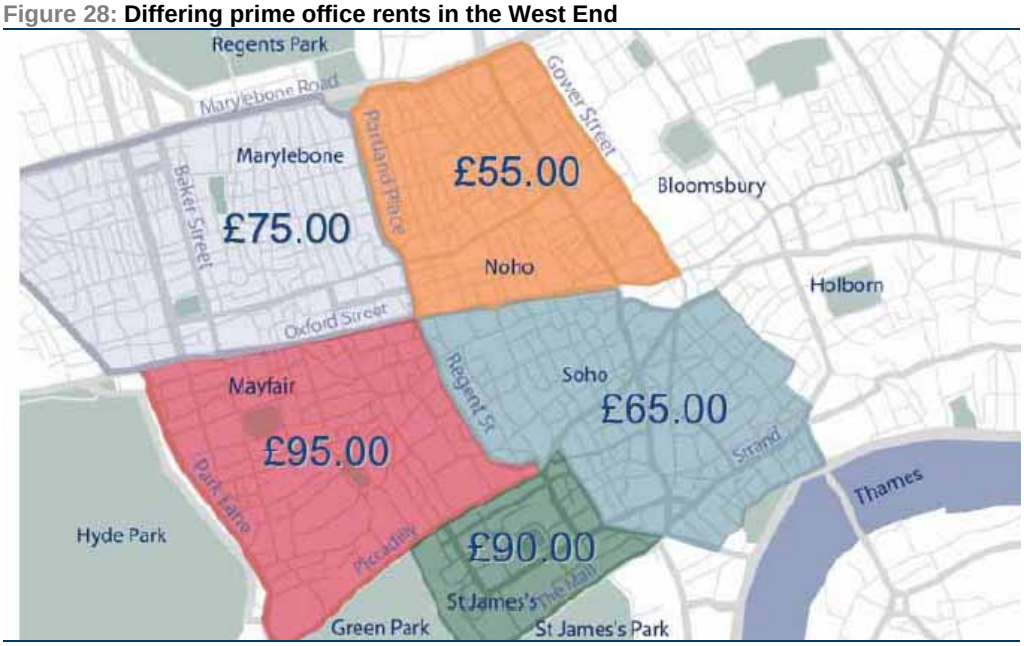
West End

The West End office market comprises a number of sub-locations or villages that offer and support varying levels of office space in terms of rental level and quality. The map of the West End shown in Figure 28 identifies four such sub locations, with Oxford Street providing a natural East/West boundary and Regent St/Portland Place on a North/South axis. A rapid fall off in rents North of Oxford St (Marylebone versus Mayfair and also NOHO versus SOHO) exists, as this market does not feature the same level of amenities as other local districts; however, this is starting to change.

Mayfair is known for its headquarters of property companies and the growing number of financial institutions (e.g. hedge funds) that operate in the area. Tenant mix can vary across the West End from media organisations to professional services. This provides an element of diversification and reduces risk to landlords.

Planning in the West End is generally in the hands of the London borough of Westminster. Planning restrictions across the borough apply, making life difficult for developers that aim to increase the net area of buildings. The height of buildings is generally restricted across the borough and supply has remained tight over the long term for this market.

Figure 28: Differing prime office rents in the West End

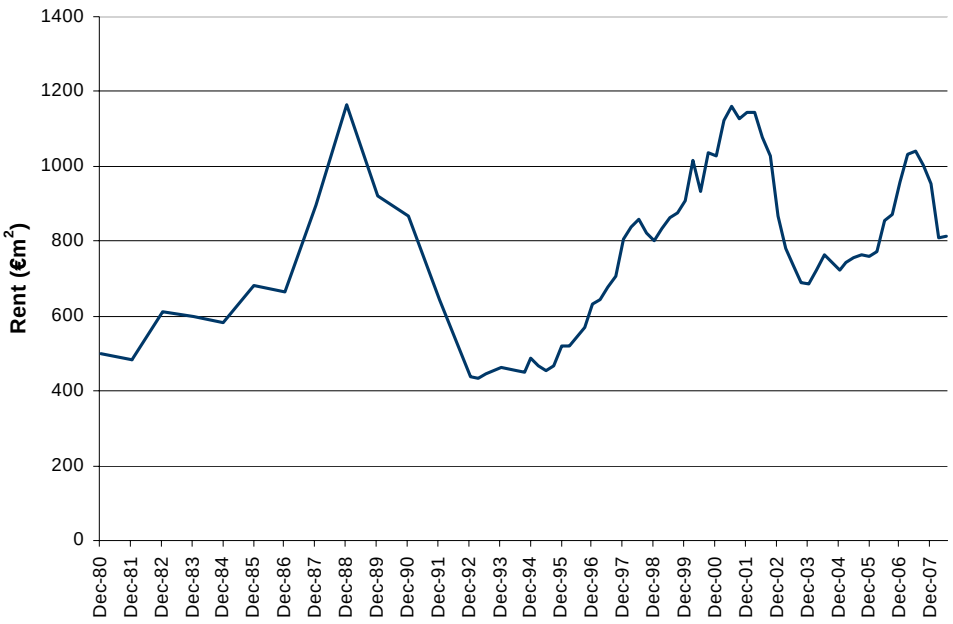


Source: Company data, Credit Suisse estimates

London city office market

The City office market is the classic cyclical 'boom and bust' market. Dominated by financial institutions and skyscrapers, the market has suffered and gained in line with economic cycles, as shown in Figure 29.

Figure 29: City office market – rental values

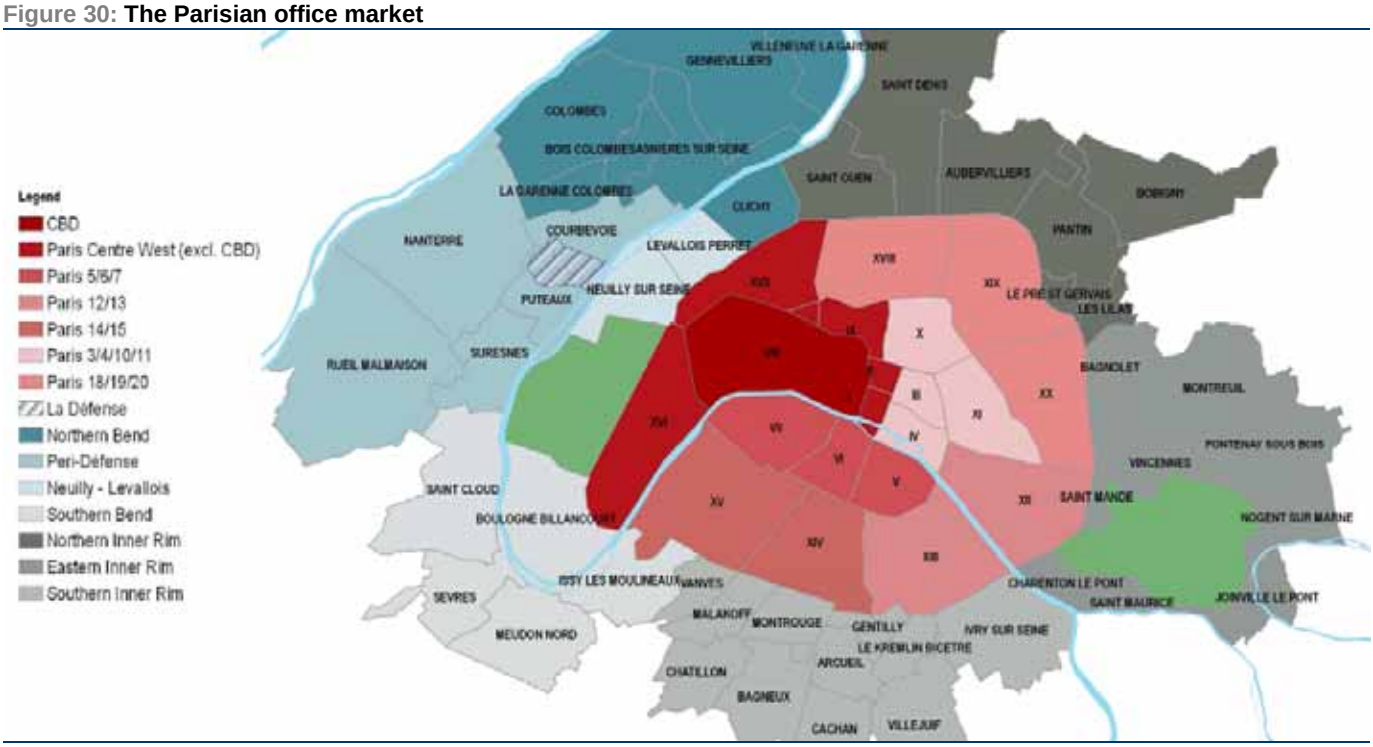


Source: Cushman & Wakefield

The main listed players operating in the office market in London are British Land, Land Securities and Hammerson.

The Paris office market

Figure 30: The Parisian office market



Source: Jones Lang LaSalle

The Parisian market shares some similarities with the London market. High rises in central Paris are rare (as in London's West End), with skyscrapers to the west of the city at La Defense. Prime rents are highest in the CBD district, at c.€700psm compared with La Defense, at c.€520psm as at late 2009. Rental values can vary between locations, asset quality etc. Between 2007 and 2009, office rents in Paris decreased by c.16% overall (less than the 40% decrease seen in London).

Figure 31: Top 10 European office markets by rent (2010)

Rank	Market	Occupancy cost/year (€pm^2)
1	London-West End	1220
2	Moscow - Central	768
3	Paris	765
4	Milan	667
5	Zurich	660
6	Luxembourg City	649
7	Stockholm	513
8	Athens	504
9	Madrid	502
10	Oslo	495

Source: Cushman & Wakefield, Occupancy cost is predominantly rent; however it includes 'other costs'

The characteristics of European Office markets can vary significantly. If you would like to discuss a particular market in detail, please contact a member of our team, who will be able guide you further.

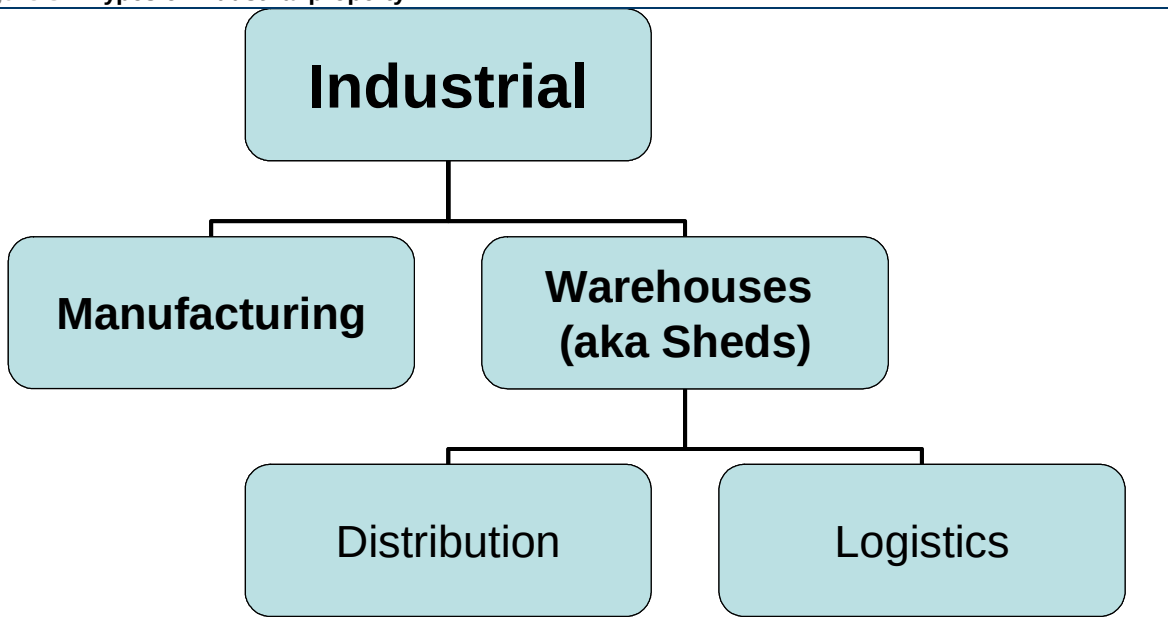
Industrial

Uses for industrial property can vary—from workshops, car assembly plants and distribution centres to self-storage facilities. Industrial property includes property of various sizes and types.

Important features for industrial property include:

- **The site/location**: Industrial properties need to be accessible by large vehicles and be near arterial routes. Any restrictions on noise, working hours etc., also need to be considered.
- **Floor loading**: Industrial property could be used to store a large number of items or machinery. The floors need to be able to support the weight.
- **Office content**: Industrial space in the UK will generally include an element of office space. On average, 10% of space is reserved for office use, although this can be considerably less for large industrial units.
- **Car and lorry parking**: Space should allow manoeuvrability for lorries.
- **Fit-Out**: Units are generally fitted out as a shell to allow the occupier to mould and adjust them to their needs
- **Shape**: Industrial space is generally of rectangular shape.

Figure 32: Types of industrial property



Source: Company data, Credit Suisse estimates

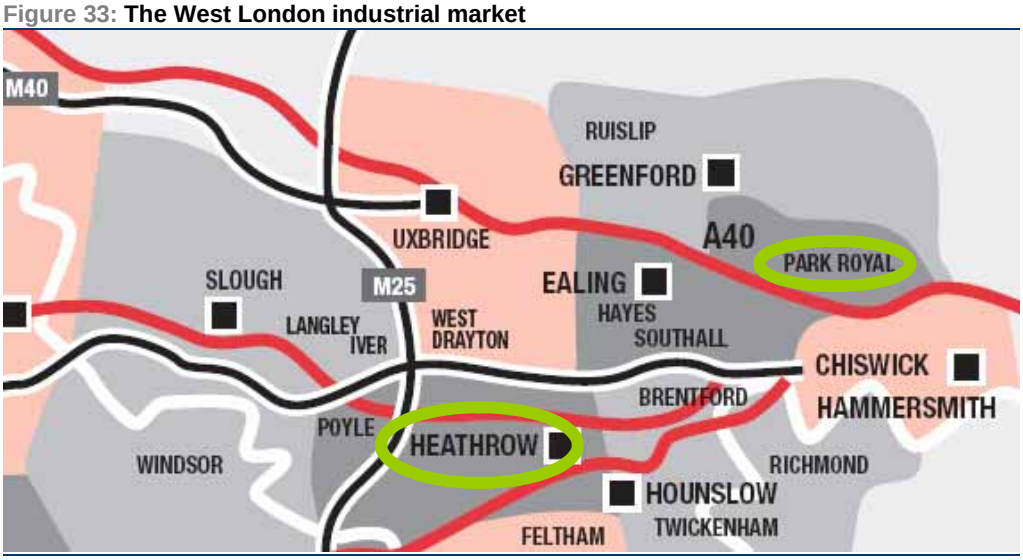
Industrial/Distribution warehouses tend to be large units (100,000 sq.ft +) and are simple to construct in comparison with other property types. They are considered long-term investments, as little maintenance is required in comparison with other sub-sectors, such as shopping centres, which are constantly being reinvented.

Industrial properties tend to be large, open and plain buildings (also known as sheds), which allows full customisation for the tenant. Tenant use can vary considerably and the landlord/developers will leave the space open for full flexibility to manage a number of uses.

West London

The West London industrial markets are predominantly focused on **Park Royal** and **Heathrow**. Two REITs, Segro and Brixton, under Credit Suisse coverage operate in these markets. Heathrow is currently the most expensive industrial space globally, according to King Sturge; however, Park Royal also remains relatively expensive owing to its location (20 minutes from the West End).

Figure 33: **The West London industrial market**



Source: Jones Lang LaSalle

European industrial markets

Figure 34: **European industrial markets – rents across Europe**

		€sqm/annum
Austria	Vienna	66.00
Belgium	Brussels	60.00
Bulgaria	Sofia	60.00
Croatia	Zagreb	70.80
Czech Republic	Prague	66.00
Denmark	Copenhagen	70.38
Finland	Helsinki	132.00
France	Paris	80.00
Germany	Frankfurt	70.80
Greece	Athens	78.00
Hungary	Budapest	78.00
Ireland	Dublin	130.00
Italy	Milan	58.00
Netherlands	Amsterdam	70.00
Norway	Oslo	138.65
Poland	Warsaw	72.00
Portugal	Lisbon	60.00
Romania	Bucharest	54.00
Russia	Moscow	99.42
Spain	Barcelona	114.00
Sweden	Stockholm	66.45
Switzerland	Geneva	126.91
UAE	Dubai	55.83
UK	London-Heathrow	180.27

Source: CBRE

Again, there are a variety of European industrial markets. Please contact a member of the team if you would like to discuss any of these in further detail.

Valuations

The valuation of commercial real estate can be difficult, hence valuers are employed to determine a potential value of an asset dependent on the reason for valuation, such as insurance, the sale of property, financing etc.

Valuation: No simple answer; one valuer can achieve a different value to another

The majority of valuations are based on the use of the comparative method, where the property valuation is based on local market comparative sales. However, with each property being different, the valuers generally need to make an educated judgement based on their knowledge and experience.

The role of a valuer

The role of the valuer is complicated. The valuer will need to compare a number of internal and external factors.

The rule of a valuer is more important for commercial property owing to the variety of property in the market—from cinemas to breweries. Each property type is distinctly difference and the valuer needs to reflect this.

Two properties, side by side, may appear similar externally; however, each can still be completely different

UK valuation standards and the 'Red Book'

The Royal Institute of Chartered Surveyors provides valuation guidance through its 'Appraisal and Valuation Standards' publication, also known as the Red Book. The book sets out a framework for valuation, guiding the valuer with a clear valuation structure. Even with the help of this book, two different valuers can attain two different valuations for a property depending on the valuer's perception of the property's future prospects and the viewpoint of the purchaser/seller.

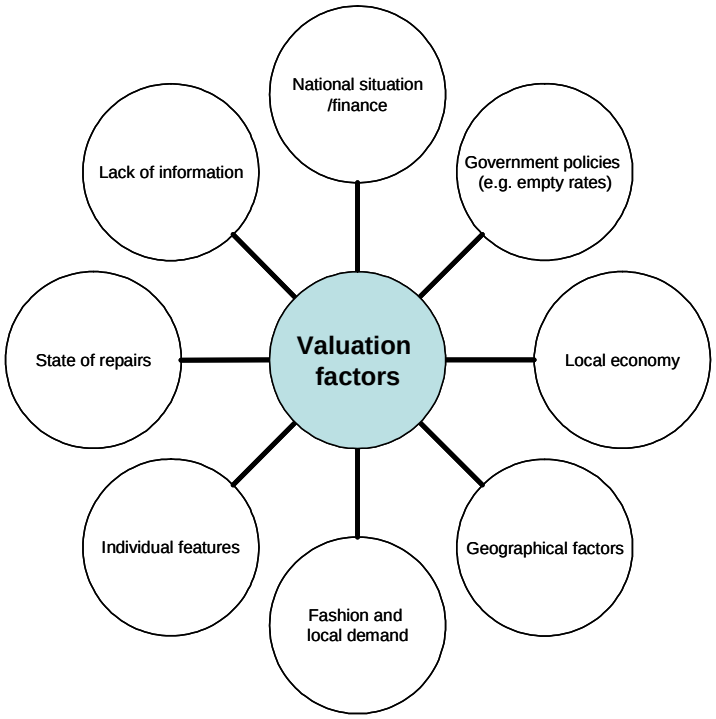
The Red Book definition of the term valuation is **'the estimated amount for which a property should exchange on the date of valuation between a willing seller and willing buyer in an arm's length transaction after proper marketing wherein parties had acted knowledgeably, prudently and without compulsion'**.

International valuation standards

Each country has its own view on valuation, although these are fundamentally negligible permutations of one another. The international valuation standards council (IVSC) were set up in the 1970s to help provide one clear definition for property valuation. The IVSC are already adopted within the Red Book and are recommended by the European Public Real Estate Association (EPRA).

Valuation factors

Figure 35: Valuation factors affecting property



Source: Credit Suisse research

Government policies

Government policies need to be constantly monitored, as a change in legislation can change the value of property.

Some examples include:

- Policies can have a negative impact on property investment; the change in 'empty rates' treatment removed vacancy relief for industrial property owners. With vacancies averaging c.10% for industrial property, the impact on operators was significant. This has been lobbied by the property industry since announcement.
- The London 2012 Olympics announcement provided capital growth to local property owners around the development site as rental growth prospects appeared more likely.

Local economy

The state of the local economy will be of importance to a valuer as a property investment is unlikely to be as attractive as a similar investment in a thriving area unless the depressed area offers value and capital growth opportunities.

- In 1980, the Chancellor of the Exchequer announced the introduction of Enterprise Zones. Briefly, these were to be a number of selected areas, relatively small in size, where it was thought preferential treatment would be desirable to encourage industrial/commercial regeneration. Development benefits included the removal of planning restrictions and requirements as well as preferential tax treatment. This policy stimulated investment into the area.

Geographical factors

Geographical factors can influence the value of a property. The aspect, latitude and topography of a site can have an impact on the value of property. The importance of these factors is dependent on the objectives of the purchaser/owner.

Accessibility

Property needs to be accessible and this is usually focussed on local transport links.

Q: Where are the major shopping centres located?

A: Usually on the edge or nearby major carriageways.

- Accessibility to major arterial roads is crucial to industrial/warehouse property, where tenants need to get goods to their customers quickly and efficiently

Individual features of a property

Each property sub-sector will have a range of specific property requirements; features include:

- design;
- functionality;
- adaptability;
- floor capacity; and
- height.

State of repair

The state of repair can affect the value and estimated rent of a property. A purchaser will factor the costs of repair into the offer or simply purchase a nearby equivalent for the same price.

Services

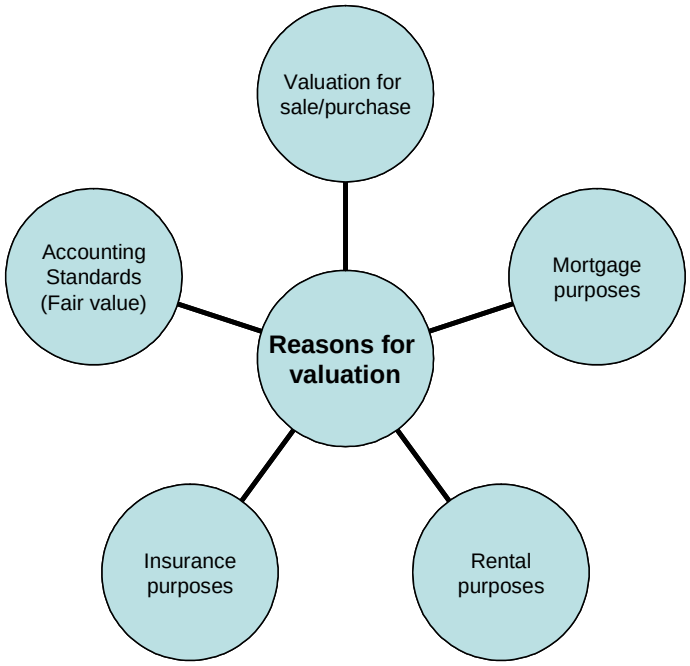
Services such as water, gas and electricity can be fundamental requirements to the majority of businesses. Some properties are not ‘wired up’ to receive such services, which may discourage a potential purchaser or tenant for the property.

Lack of market information

Unfortunately, there continues to be a lack of market information in many property markets, making the purchase process more difficult and often causing purchasers to overpay for property.

Why value?

Figure 36: Reasons for valuations



Source: Credit Suisse research

Valuations for sale/purchase

A seller or purchaser may request a valuer to value the property before they buy/sell. The seller may be interested in the potential sale value of the property, with the valuer needing to consider potential purchasers and local alternatives.

Mortgage purposes

A lender will be interested in the value of the property as the mortgage loan will generally be secured against the property. The valuer will provide an open market value for the mortgage, but also a forced sale value in the case the purchaser defaults on the mortgage.

A forced sale value in the current market may be materially different from the open market value.

Rental purposes

An owner of a property may wish to know the current rent for the property. This may vary depending on the use and tenant-specific matters. For example, a tenant with a strong covenant and long lease may be able to obtain a more favourable rent. The valuer would also need to consider a tenant's background.

Insurance

A valuation created for insurance purposes values how much it would cost to rebuild the property if it was destroyed. This may be unlikely, although many mortgage contracts stipulate that building insurance be in place.

It is common for a building replacement cost to be significantly less than its valuation.

Accounting standards

Valuation in relation to the various accounting standards will be discussed in greater detail later in this primer.

Depending on the accounting standards applied, property companies may find that they have to revalue their properties to 'fair value' (i.e. the current market value of the property as at the balance sheet date). In recent years, property companies that utilise 'fair value' accounting practices have seen significant uplifts in valuations—as well as the negative impacts seen in the last two years.

Valuation methods (direct property)

We consider five valuation methods:

The most important valuation method to consider is the 'comparative method'.

- comparative method;
- contractor's method (where comparables do not exist);
- development method;
- capitalisation rate; and
- discounted cash flow.

Comparative method

- The most common method of valuation used by valuers
- Valuations are based on a simple comparison of a property to comparable assets sold in the marketplace. Ideally, comparable evidence should be recent, especially in fast-changing markets like that we are currently experiencing.
- This is no simple task, as each property is distinctly different from another.
- Factors to consider include internal specification, variation in floor space, age of building, fixtures and fitting, location etc.
- There are some property sub-markets where comparable evidence is difficult to come by. For example, prime shopping centres are rarely traded assets, which makes the valuation of the Liberty international portfolio a challenging task.

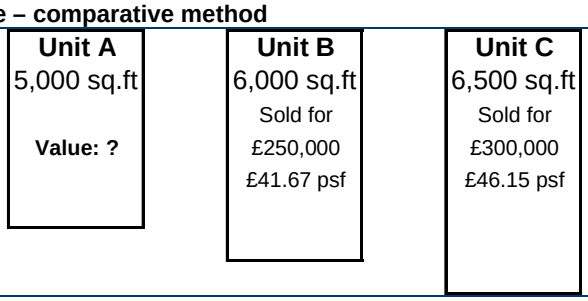
Example – Comparative method

A valuer is valuing an industrial unit (A) of 5,000 sq.ft. In the past year, there have been an additional two industrial units sold in the same estate.

Unit B of 6,000 sq.ft unit was sold for £250,000 12 months ago. Unit C (6,500 sq.ft) was sold for £300,000

We note that Unit B was sold for £41.67 per sq.ft one year ago, whereas Unit C was sold for £46.15 per sq.ft. Between the sale of Unit B and C, the value per sq.ft rose £0.74 per month. We could assume value continues to rise at the same rate, hence the value per sq.ft of similar asset per sq.ft would be an £50.59 per sq.ft (£46.15 + £4.44).

Figure 37: Example – comparative method



Source: Credit Suisse estimates

We could assume the value of Unit A is £50.59 x 5,000 sq.ft = £252,950.

Admittedly, this is very simple example and there are a host of other factors to consider here, but this provides a demonstration of how the comparable method works. Other factors could include additional land, car parking, office space, quality of the building, current use, the actual plot etc. We also assume values continue to rise, which may not always be the case, as seen in the current market.

The comparative method focuses on recent sales, which could also be affected by other factors. For example, Unit B may have been sold to an adjoining Unit holder who wanted space to expand and was therefore keen to buy and pay a premium for the property. Valuers will need to carefully assess comparables before relying on them completely.

Despite the numerous caveats, this method of valuation can provide a reliable and clear result for a valuer – in stable markets of course!

Contractor's method

- This method of valuation is common for property where comparables are rare or even non-existent.
- This method simply states that the cost of land plus the cost of the building will equal the total value of the real estate.

Figure 38: Contractor's method

Cost of Land
+
Cost of Building
Total value of property

Source: Credit Suisse research

- This method is rarely used, as the value may not be realistic and there tends to be a sufficient level of comparables in the marketplace again, under normal conditions.
- The contractor's method is used for valuing property such as hospitals, libraries and police stations.
- An adjustment to the valuation could be made for depreciation and obsolescence.
- This method may prove unreliable as the cost of land and building may be difficult to ascertain. These costs can vary depending on materials required, labour costs etc. The judgement of the valuer is key when using this method.

Development method

- This valuation method is used where a property has development potential.
- A value of the property is ascertained based on the residual value of the property, taking into account the total value of the completed development (i.e., gross development value) minus total expenditure on the development.

Figure 39: Development method

	Value of the completed development
Less	Total expenditure on improvements or development (inc. developer's profit)
	Value of the site or property in its present condition (Residual value)

Source: Credit Suisse research

- This form of valuation can be difficult, as the valuer will need to decide which use will provide the highest gross development value and then decide on the total cost of expenditure.
- The cost of expenditure will need to consider a number of items, including architect fees, surveyors, legal fees, contractors, estate agent fees, cost of finance, etc.
- The developer will also require a profit for its work, which needs to be considered in the valuation.

- The cocktail of expenditure variables will usually mean one valuer will come up with a completely different value from another.

Figure 40: Example – Development method

	A parade of four retail shops:		
	Gross development value:		**£1,000,000**
	Less: Costs of development:		
1	Building costs	£ 650,000	
2	Professional fees (10% of building costs)	£65,000	
3	Cost of borrowing	£32,500	
4	Legal expenses, say,	£15,000	
5	Agent's fee on sale, say,	£17,500	
6	Advertising costs on sale, say,	£7,500	
7	Developer's profit	£75,000	
	Total development cost	**£ 862,500**	
	Residual sum		**£137,500**

Source: Credit Suisse estimates

- Our example shows the developer has allowed £137,500 for the value of the land. The developer will also need to consider the costs associated in purchasing the land and the time value of money, as the land cost is generally sunk until development is complete.

The capitalisation method (also known as the Investment method)

- This is a common valuation method for investment property.
- This method can still be used for vacant property (i.e. no income stream), although the valuer will assume an estimated rental flow
- A valuer will use the annual income to base a value on the capital value of the property.
- The income multiplier is also known as 'Year's purchase'—essentially based on the rate of interest the investor would require.
- This rate of interest (or yield) required from the investment will be dependent on a number of factors. Once again, there will be an element of comparison to similar investment properties.
- The yield applied to an investment property is also known as 'the all risks yield', that is, the yield used to allow for all the good and bad features of a property.
- This method of valuation, despite its simplicity, is still used widely today. The yield provides a clear yardstick for investors to compare against other investment classes such as equities and gilts.

Reminder: Investment property is property with an income producing tenant.

Figure 41: Example – Investment method

Property	Net Income	Capital value	Yield	Multiplier (1/Yield)
Factory	£15,000	£135,000	11.1%	9
Factory	£16,500	£150,000	11.0%	9.09
Factory	£67,500	£615,000	11.0%	9.11
Shop	£7,500	£ 93,000	8.1%	12.4
Shop	£10,500	£130,000	8.1%	12.38
Shop	£13,500	£170,000	7.9%	12.59
Offices	£45,000	£650,000	6.9%	14.44
Offices	£120,000	£1,700,000	7.1%	14.17

Source: Introduction to property valuation

- As can be seen in Figure 40, the lower the yield an investor is prepared to accept, the higher the multiplier with which the income flow will be capitalised. It follows that if two investors are interested in one property, the investor who is prepared to accept the lowest yield will place the highest capital value on the property, and vice versa.
- The results of this analysis are likely to be more useful and reliable where a number of similar properties exist. The valuer must attempt to use what evidence there may be as intelligently as is possible.

Therefore, the higher the yield an investor requires, the lower the capital value. The converse also applies.

Discounted cash flow

- The Net Present Value method is where all future income (and expense) is discounted to a net present value by using compound interest calculations.
- The NPV approach is a very useful method of analysis and enables investors to determine whether investments are likely to prove acceptable at a given target yield.
- The target yield (discount rate applied) required is crucial and enables alternative investments to be compared to show a profit/loss. This could depend on the cost of borrowing, the opportunity cost of money and the risk rating of the particular investment.
- **Example**: A property is on offer at £85,000, for which the expenses of purchase would be £4,000. It is let for four years on internal repairing terms at a rent of £10,500 pa receivable in arrears. It is anticipated that it could be sold after four years for £112,000, the estimated costs of sale being £6,000.
- The profit on this example is £5,464 using a discount rate of 12%. A higher discount could make the property purchase unprofitable.

Figure 42: Example – simple net present value

End of Year	Particulars	Outflow	Inflow	Net Flow (+ or -)	PV of £1 @ 12%	Net Outflow	Net Inflow
0	Purchase Price	-85,000					
	Purchase Costs	-4,000		-89,000	1.00	-89,000	
1	Rent		10,500				
	Repairs	-700					
	Insurance	-220					
	Management	-525		9,055	0.89		8,085
2	Rent		10,500				
	Repairs	-770					
	Insurance	-242					
	Management	-525		8,963	0.80		7,145
3	Rent		10,500				
	Repairs	-847					
	Insurance	-266					
	Management	-525		8,862	0.71		6,308
4	Rent		10,500				
	Repairs	-932					
	Insurance	-293					
	Management	-525					
	Sale proceeds		112,000				
	Sales Costs	-6,000		114,750	0.64		72,926
						-89,000	94,464
Net Present Value							**5,464**

Note: Management costs are calculated as 5% of rent received

Source: Credit Suisse research

Internal rate of return

The IRR method shows the rate at which an investment earns money. The Net Present Value method simply showed the profit/loss depending on the rate of return required. The IRR simply shows the break-even point/yield at which the investor will start to earn a profit.

Yields

The basics

The yield on a property investment provides the investor an indication of the level of earnings from the property.

- For example, a 5% yield would pay £5 pa for every £100 invested

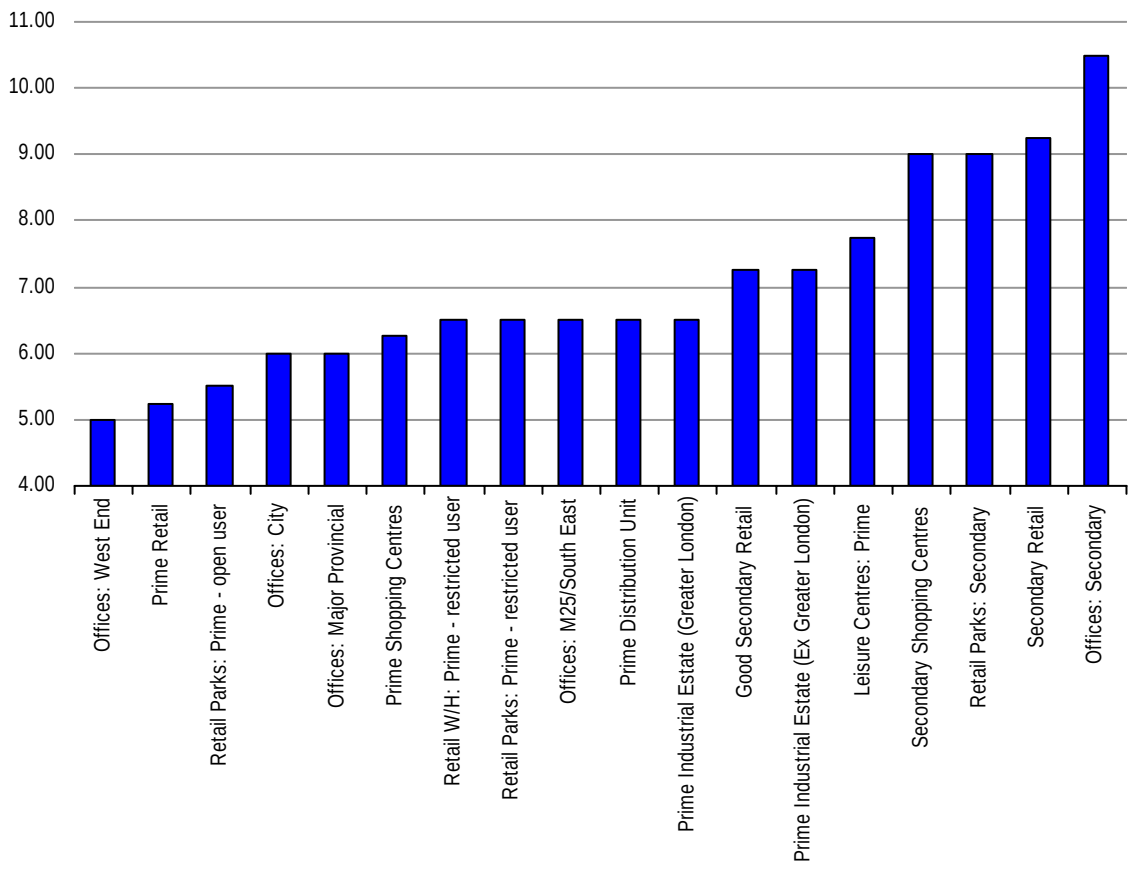
In essence, the higher the yield, the more attractive the investment; however, this usually also indicates a higher degree of risk. Unfortunately, there are a few more factors to consider than picking the property offering the highest yield.

Investors will always be evaluating the yield on a property investment compared with alternative investments such as Gilts (the risk free rate). For a REIT, an investor may be focussed on the dividend yield in relation to the risk of the underlying property portfolio.

Yields on property investments can vary depending on the property sub-sector.

- For example, an out-of-town shopping centre may offer a yield of 5%, although an industrial warehouse may offer a yield of 8%. Investors may consider the shopping centre a more secure investment assuming rental income to be more resilient in comparison with the industrial warehouse.

Figure 43: UK: Yields across the various property sub-sectors (December 2009)



Source: CBRE

The three main property yields are:

- Net initial yield: Net income expressed as a percentage of the gross purchase price including the costs of purchase
- Reversionary yield: The estimated rental income from property expressed as a percentage of the purchase price.
- Equivalent yield: The weighted average yield between initial and reversionary yields.

Net Initial yield (also known as income yield)

The net initial yield is a common measure that investors can use in relation to alternative investments. This yield is based on net rental income currently earned by the portfolio over gross purchase price including property costs of 5.765% (a UK-specific amount).

Figure 44: Net Initial Yield

$$\frac{\text{Net Income}}{\text{Gross pruchase price including the costs of purchase}} = \frac{\text{Income from property after deduction of all outgoings, annualised (e.g. repairs, insurance, management costs)}}{\text{The gross purchase price including costs of purchase (5.7525\%)}}$$

Source: Credit Suisse research

Figure 45: Net Initial Yield – Example

Rental Income	£10,000	Net Initial Yield
Outgoings	-£1,000	= £9,000 / £158,644
Net Rental Income	£9,000	
Gross purhcase price	£150,000	**= 5.67%**
Costs of purchase (5.7625%)	£8,644	
Total purchase cost	£158,644	

Source: Credit Suisse research

Gross initial yields are also used—the only difference with the gross initial yield is that it does not include the costs of purchase (5.7625%), the argument being that a buyer's cost of purchase can vary considerably. Some companies quote a gross yield rather than net initial yield, which could inflate the yield, providing an inflated yield for the asset/portfolio.

Note: Costs of purchase can vary across Europe

Net reversionary yield

The estimated rental income from property expressed as a percentage of the purchase price.

In the UK, rents are fixed and reviewed every five years. Between this five year period, an 'open market rental value' (OMRV) is established for the property based on numerous factors, such as supply/demand. The net reversionary yield is uses the open market rent for the property, in comparison to the net initial yield, which applies the current rent achieved.

Figure 46: Net Reversionary Yield

$$\frac{\text{Market Rent}}{\text{Gross purchase price including the costs of purchase (5.7625\%)}}$$

Source: Credit Suisse research

Figure 47: Net Reversionary Yield – Example

Market Rent	£14,000	Net Reversionary Yield	
		=	£14,000
Gross purchase price	£150,000		£158,644
Costs of purchase (5.7625%)	£8,644		
	£158,644	=	**8.82%**

Source: Credit Suisse research

Equivalent yield

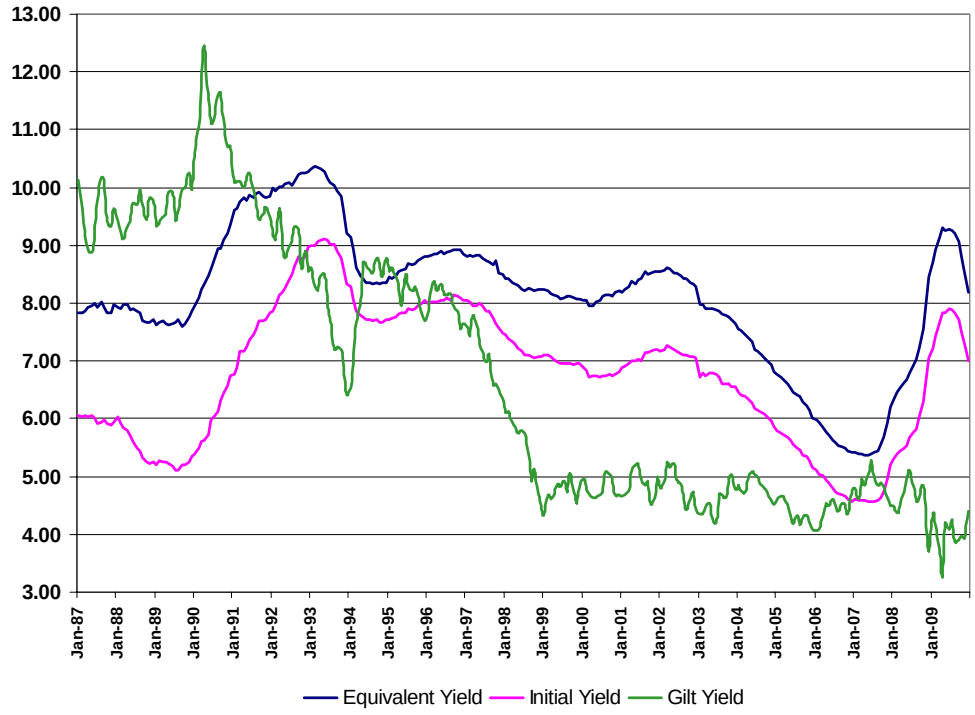
The equivalent yield is the weighted average yield between initial and reversionary yields. To be more precise, the internal rate of return from an investment property reflecting reversions to current market rent, and such items as voids and expenditures, but disregarding potential changes in market rents.

There are two key definitions of equivalent yields: 'true equivalent yields' and 'nominal equivalent yields'.

Nominal equivalent yield: This yield assumes rent is received annually in arrears.

True equivalent yield: This yield reflects the actual timing of cashflows. In the UK, rents are receivable quarterly in advance; hence the true equivalent yield provides a fairer reflection of the equivalent yield.

Figure 48: Equivalent yield vs Initial yield (January 1987 – February 2010)

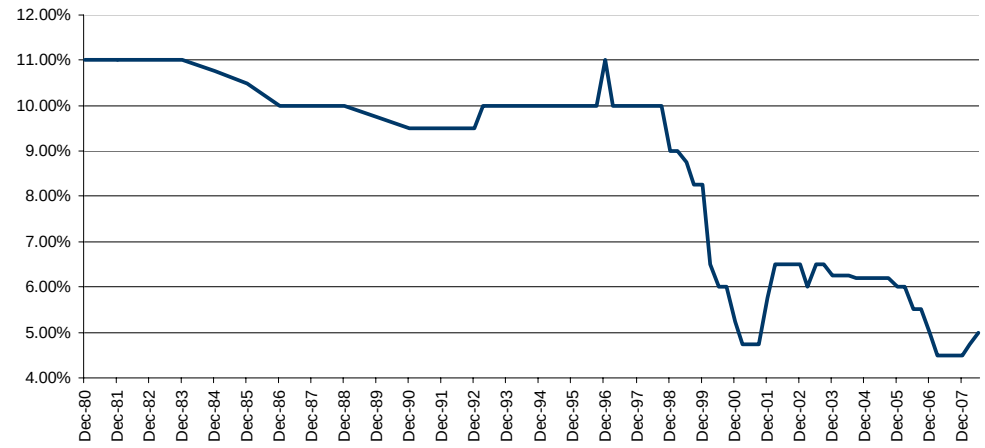


Source: Company data, Credit Suisse estimates

Yields across Europe

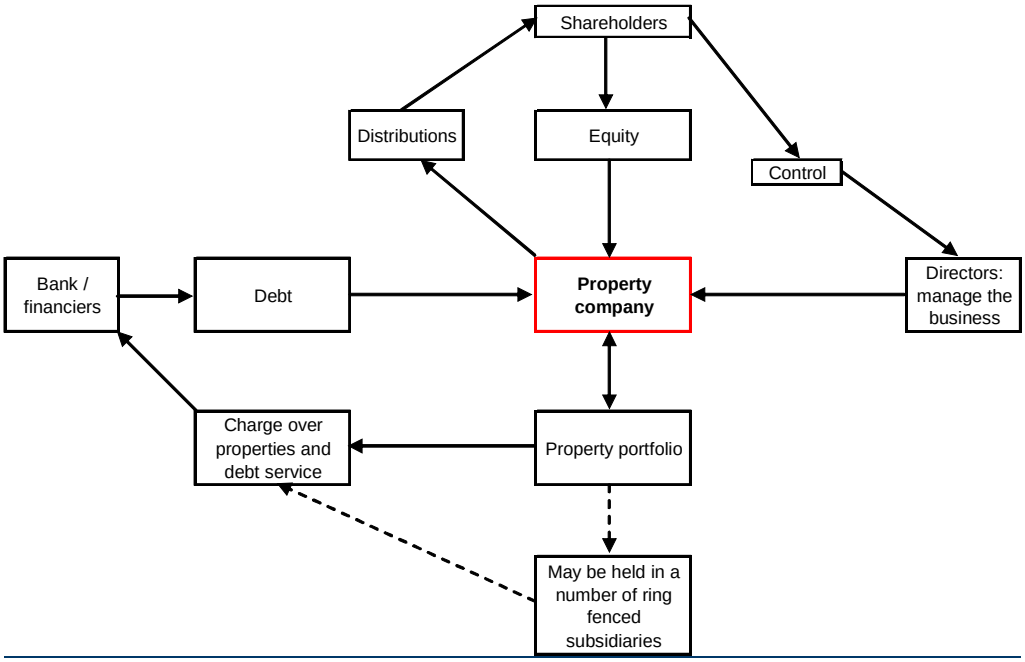
As with the UK, historical yield data is available across all the major European office and retail markets. This allows investors to compare the various real estate markets and assess opportunities from a top-down approach. We highlight in Figure 49 how a yield can change over time from one particular European market.

Figure 49: Office yields in Cork, Ireland from 1980



Source: Cushman & Wakefield

Figure 50: Typical Property company structure



Source: Real Estate Appraisal

Commercial property can range in value from a high street shop costing £400,000 to a regional shopping centre valued at £1.0bn. Most property investors will purchase commercial property using a mix of debt (e.g. a mortgage) and equity (i.e. the money provided by the investor).

There are a number of financing sources that an investor can tap, each providing a number of advantages and disadvantages. The amount, cost and terms of financing can vary with debt providers concerned with the level of security, the macroeconomic environment, reputation of the borrower.

Commercial property lending is more expensive than residential housing loans as lenders consider there to be greater risk with commercial property compared with residential. The majority of property transactions will have an element of debt and equity.

Why do investors want to bring debt on board?

- To increase their return on equity
- To limit their exposure to single investments
- To increase the amount of capital to invest in property, allowing access to larger and potentially more attractive opportunities

Using debt financing to supplement the use of equity money is known as ‘gearing up’ the finance and this could potentially increase an investor’s return of equity.

Debt

Debt finance is the principal amount borrowed. Debt remains constant throughout the borrowing period unless an investor repays the finances during the term of the loan. The capital repayment can be paid during the loan period or as one large capital payment at the end of the term.

Interest payments

Interest payments on the loan are agreed at a specific rate. This rate may be fixed for the term of the loan, in which case for short- to medium-term loans the interest rate will be linked to the prevailing SWAP rate at the beginning of the loan, plus a margin.

Longer-term loans are generally linked to the Bank of England base rate (rare) or to 3/6-month London Inter Bank Offer Rate (LIBOR). The timing of the payment is agreed between the lender and borrower.

Cautious lenders

Lenders have grown increasingly conscious about whom they lend to since the credit crunch, with the cost of financing increasing with higher margins and additional fees charged by the lenders.

The risk of non-payment of the interest and capital outstanding is known as the **default risk**

Banks are likely to be even more cautious on lending since the introduction of Basle II, which states a risk assessment criteria that banks will now be required to fulfil.

Equity

Equity is the investor's own money invested in the property. Gearing is the ratio that describes the amount of debt and equity invested in a deal. However, the gearing ratio is measured in two different ways:

Figure 51: Gearing formulae

$$\text{Debt to Equity} = \frac{\text{Net Debt}}{\text{Equity (Net Assets)}} \qquad \text{Loan to Value} = \frac{\text{Total Debt}}{\text{Gross Assets}}$$

Source: Credit Suisse research

The impact of gearing

As the level of gearing to finance an investment increases, so does the volatility of the achieved returns. The level of gearing can also leave the lender vulnerable to a decline in property value.

Gearing: can magnify gains and losses of a property investment.

Where property values fall below the amount of borrowings, the lender is exposed to a potential loss, as there are insufficient assets to meet the repayment of the borrowings; therefore, it is key to be able to spot the peaks and troughs of a cycle to ensure a strong return on equity.

Gearing examples

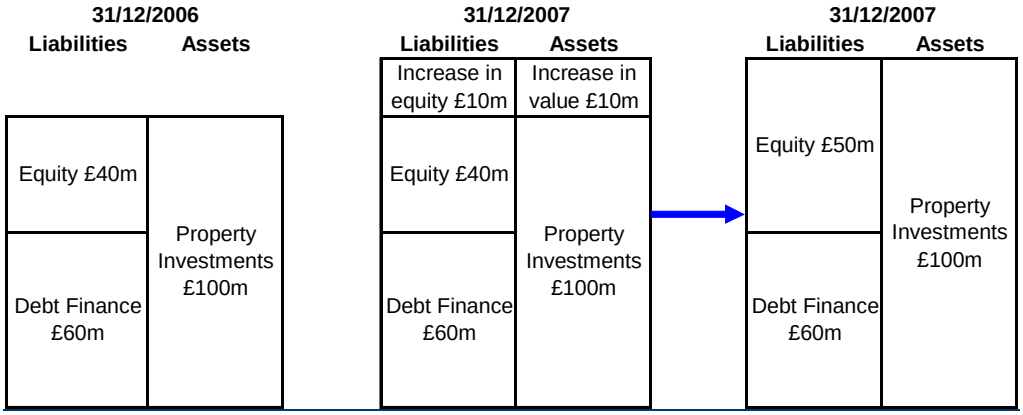
Example 1:

An investor purchases £100m of property with £60m of debt and £40m of equity as at 31/12/2006. As the property portfolio (assets) in the company changes in value, these changes are reflected in the liabilities.

The value of the property increased by £10m at the annual revaluation as at 31/12/2009.

The result of this is that the equity has increased from £40m to £50m, representing a 25% increase. As a consequence of the use of gearing, a 10% increase in property values has been translated into a 25% increase in the investor's equity (or the net asset value of the company).

Figure 52: Example 1: Gearing

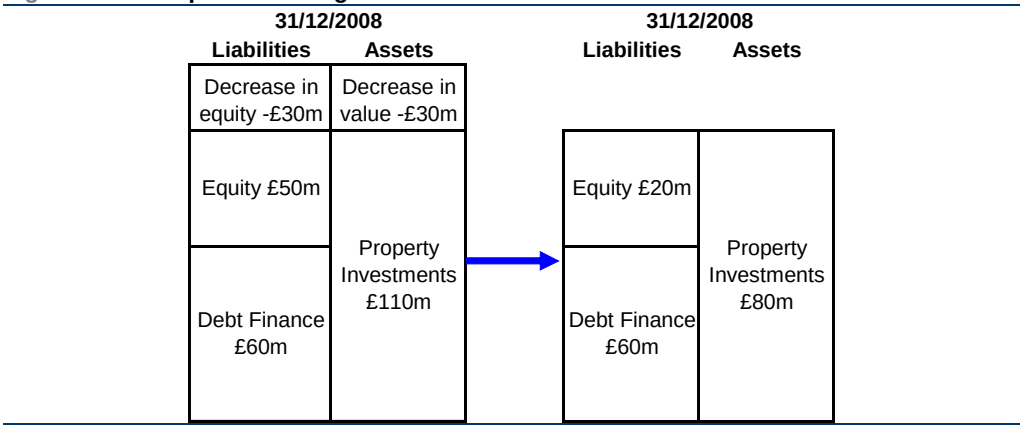


Source: Company data, Credit Suisse estimates

Example 2:

In contrast to example 1, if asset values fell 27% (from £110m to £80m), there would be a revaluation deficit of £30m, which would be deducted from the equity representing a 60% diminution.

Figure 53: Example 2: Gearing



Source: Credit Suisse research

Gearing has the ability to rapidly change returns in a rising market while diluting equity in a falling market.

Lender considerations

The lender's primary concern is to ensure that the interest payments, their fees and capital repayments will be paid on the due dates. Loan agreements will often feature a number of covenants, where if breached, the loan is repayable, a higher rate of interest is charged or the bank will expect an injection of equity,

A lender will consider two key ratios

- Initial loan to value (ILTV)
- Interest cover (IC)

The initial loan to value is calculated by dividing the loan by the value of the gross property assets net of purchasers costs. Valuations for most property companies are completed either quarterly or semi-annually by an independent valuer providing the lender with a clear indication of the current ILTV. The average LTV for the UK REITs is c.49%; however, across the private sector, LTVs are closer to 70% (Jan 2010). The higher an ILTV, the greater the risk for the lender.

Independent valuers include CBRE, Jones Lang LaSalle and Knight Frank

Interest cover

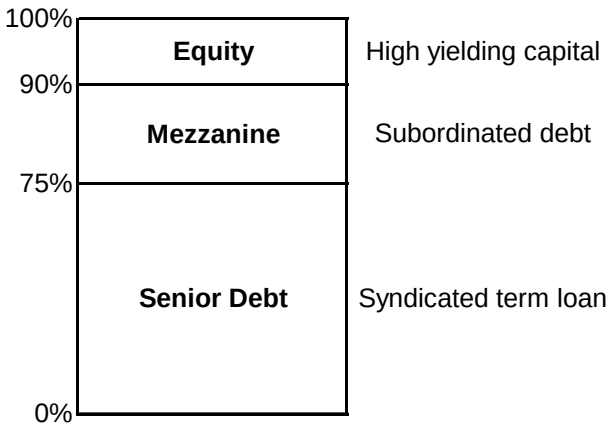
The interest cover ratio is calculated by dividing the annual net rental income by the annual interest payments. The interest cover will depend on the quality of the covenant; for example, a strong covenant with a long lease may have an interest cover of around 1.2x, whereas an investment property with a weaker covenant may have an interest cover of 1.5x.

UK REITs have to meet an interest cover of at least 1.25x as part of REIT rules

During the term of the loan, if the borrower has breached its covenant, the lender may request an equity injection to bring the covenants back in line. This is not an ideal outcome but can happen in weak property markets, as we are experiencing currently.

Layered debt

Figure 54: Layered debt



Source: Real Estate Appraisal

Senior debt

Senior debt is secured on the property. Lenders prefer to lend on property let to a strong covenant on a long lease limiting the risk of default. In turn, the interest margins will be lower and the LTVs stretched further. Secondary or even tertiary property will offer significantly higher interest margins to take into account the additional property risk.

Banks may offer competitive lending margins but will try to claw back additional returns by requiring either or both up-front and exit fees. These fees can include:

- Arrangement costs (30–50bps)
- Commitment fees (15–25bps)
- Exit fees (10–25bps)

Figure 55: Interest margin costs

Secured (2006)	**50–100bps**
Secured (2010)	**100–300bps**
Developer (if available!)	**300+bps**

Source: Credit Suisse estimates

Some lenders will require the investor to limit risk by entering into a hedging instruments such as an interest rate swap to fix their cost of finance.

Mezzanine finance

Mezzanine finance sits between senior debt and equity. The lenders of mezzanine finance do not have first charge on the property and the rental income, and hence take on additional risk.

This form of finance provides the lender with three elements from which to earn returns:

- Interest rate: This is set at a higher margin to reflect the higher risks involved.
- Fees: These are charged upfront, but may be added on to the loan amount. In terms of the costs of the funds, fees can be significant. In some instances an exit fee may be charged, but this normally subject to negotiations.
- Performance link: A performance-related element is usually included, which gives the lender a percentage of the surpluses.

Where there are two funders providing mezzanine finance, one will be 'senior' and the other 'junior' and, as the words suggest, the senior mezzanine funder will take the less risky 'slice' of the income and junior funder will be in a more vulnerable position.

Figure 56: UK: Listed REITs – Examples of covenants

Company	Covenants
Hammerson	Gearing covenant of 150%
Land Securities	Most of Land Securities' debt is secured against a large pool of assets (the Security Group). Its LTV covenant introduces operational restrictions if it breaches 65% and further restrictions at 85%. Default is triggered at 100%.

Source: Company data

Interest rates

Interest rate charges are either:

- Variable: The rate of interest is fixed in relation to either the 3/6-month LIBOR (or the BoE base rate)
- Fixed: The rate of interest is fixed in relation to either SWAPs, where the duration of funding is fixed for usually five years. Some lenders will request that borrowers limit their interest rate liability.

Non-recourse debt is where, on default, the lender is given access to only the property asset. There is no access to the borrower or the borrower's other assets.

Managing interest rate risk is vital for any borrower. Interest rates can vary and we have seen from recent times that LIBOR can be volatile. An increase in interest rates could leave the borrower with insufficient rental income to meet their repayment liability. It is common for some lenders to request that the borrower mitigate this risk through an interest rate risk hedging instrument. An investor can do this by applying cap/floor/collar or applying a SWAP instrument.

An **interest-rate cap** will limit an investor's exposure if interest rates move above a certain level (agreed in the terms of the finance documentation) in return for an upfront premium. Essentially, the cap will provide the borrower a ceiling on the interest rates payable.

An **interest rate floor** provides the lender with a minimum interest rate. However, most borrowers do not mind if interest rates fall; hence floors are predominantly used to limit the cost of a cap.

An **interest rate collar** will combine a cap and a floor; this tends to be the cheapest alternative for borrowers, but ties the borrower into a specified minimum interest rate.

The interest rate SWAP instrument is commonly used by borrowers. The SWAP contract allows one party to exchange a variable interest-rate obligation with a fixed-rate obligation, or vice versa. This is regularly used to SWAP variable-rate borrowings into fixed-rate debt. The lending bank will usually charge a 'facility fee' for arranging the SWAP transaction.

A lender will also charge a margin above the SWAP rate; the SWAP is regularly compared to the property initial yield.

Other forms of finance

Other forms of finance outside bank borrowing include:

- Mortgage
- Loan stock
- Deep-discount and zero-coupon bonds
- Rights issues

Mortgage debentures are issued by property companies (REITs) secured on the property assets and rental income of the property. This type of finance is long term with lives spread across 15 and 40 years. The investor will receive a bond-like income during the term of the loan.

They usually come with an interest cover covenant that is at least 1.1x. Mortgage debentures have interest-only payments, and the capital is repaid at the redemption date. The interest is at a fixed coupon and mortgage debentures are a tradable form of debt funding.

The difficulty with this form of financing is they are long term and to redeem the debt, a company will have to go back into the market and repurchase the debt.

Under accounting standards, this form of debt should be shown in the accounts at market value. This is known as marking debt to market.

A **zero-coupon bond** is where there is no interest payable and the entire interest is rolled up and paid at the redemption of the bond. This method of finance offers the property company strong positive cash flows during the life of the bond.

An unsecured loan stock is used where short- to medium-term debt finance is required and the debt normally has a maturity of less than ten years. Finance is generally raised through the commercial banking sector. As the loan is not secured, it does not 'use up' property assets on the balance sheet. Due to the unsecured nature of the debt, it is usually more expensive than mortgage debentures.

Securitisations

Securitisation is an additional method of raising debt. The process involves the creation of asset backed securities (ABS). The ABS is a type of debt security based on an underlying pool of assets. The assets are pooled together to provide an investor the opportunity to invest in assets which on their own, would not be worthwhile.

This is ideal for illiquid investments such as direct real estate.

The process of creating an ABS involves the transfer of assets from the issuing company (e.g. British Land) to a bankruptcy remote entity (e.g. Broadgate financing plc). Grouping a number of assets into a special purpose vehicle separated from the issuer creates a security that has a higher rating than the issuing company from the credit rating agencies; which allows the issuing company to monetise assets while paying a lower rate of interest than other forms of debt finance. One common form of ABS is Commercial Mortgage Backed Securities (CMBS).

The first major UK securitisation was in 1987 (involving residential mortgages). The assets originally used were debt assets that generated a flow of income, such as mortgages.

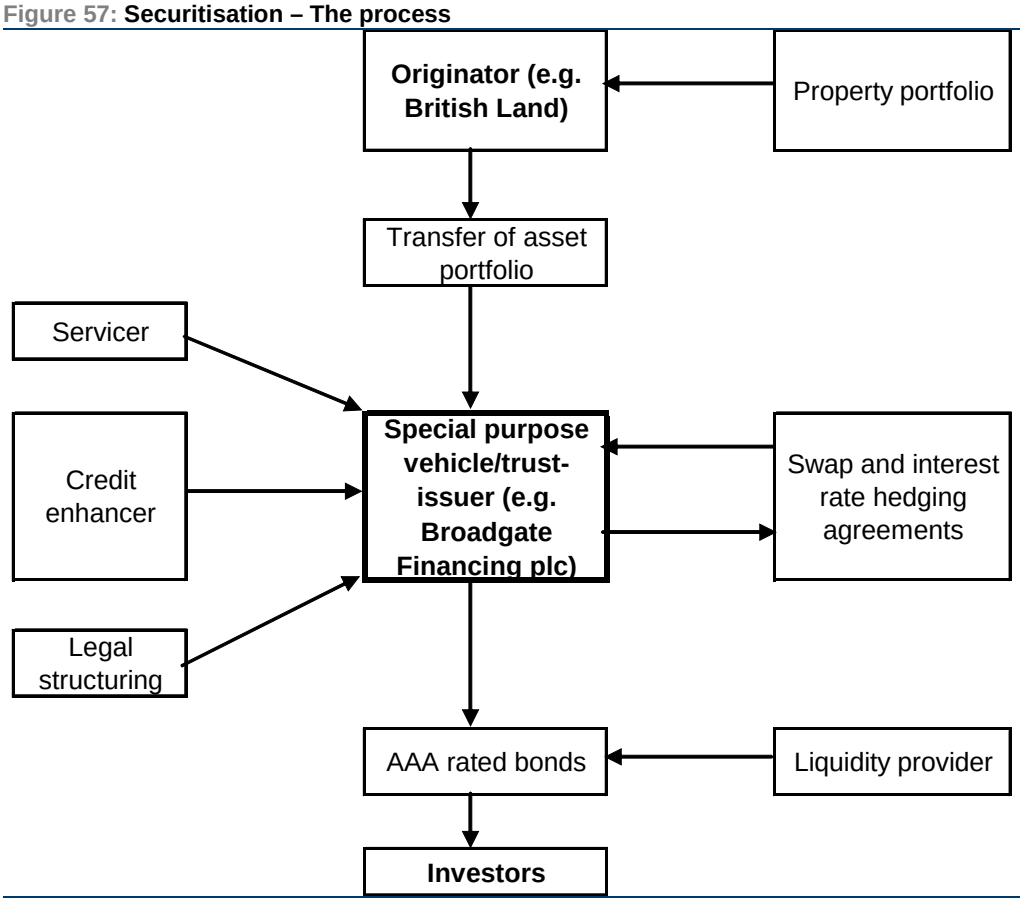
Securitisation structures are quite complex, so they tend to be used to raise substantial amounts of finance. Banks and financial institutions regularly securitise loan and mortgage books with values in excess of £1bn (thus freeing up capital for further lending), and single whole business or income stream securitisations in other industries can exceed £2bn.

Securitisation is used as a method of funding for two main reasons:

- it is an effective way of raising finance at a competitive rate that is generally less than traditional bank lending or bond issues; and

- it improves the funding options of the borrower (diversification)—a securitisation enables an entity to benefit from capital market financing which it would otherwise not have access to because its overall credit rating is not strong enough.

Figure 57: Securitisation – The process



Source: Real Estate appraisal

Example – British Land securitising its Broadgate portfolio

British Land has used the securitisation process to fix its debt at relatively low rates over the long term. In 2005, Broadgate Financing plc, a newly established ring-fenced subsidiary of British land issued £2.08bn of bonds supported by cashflows from the Broadgate estate in the City of London. The bonds featured an average weighted average interest rate of 5.05% and a weighted average maturity of 16.9 years.

The bonds issued by British Land by securitising the existing Broadgate mortgages are detailed below.

Figure 58: Tranches within the securitisation (Broadgate Financing plc)

£m	Class	Bonds due	Rating
225	A1 Floating Rate	2032	AAA/Aaa/AAA
315	A2 4.949 per cent	2031	AAA/Aaa/AAA
175	A3 4.851 per cent	2033	AAA/Aaa/AAA
400	A4 4.821 per cent	2036	AAA/Aaa/AAA
365	B 4.999 per cent	2033	AA/Aa2/AA
235	C1 Floating Rate	2022	A/A2/A
215	C2 5.098 per cent	2035	A/A2/A
150	D Floating Rate	2025	BBB/Baa2/BBB

Source: Company data

The ratings are independently completed through agencies such as Moody's / Fitch.

Capital Markets

Real Estate Investment Trusts (REITs)

The label 'real estate investment trusts', or REITs, applies to several different property investment vehicles in various countries. However, they share a common feature: they generally own and manage income-producing property, distributing most of their income to shareholders through dividends. In return, the REIT is largely exempt from corporation tax.

Source: Extracts of this section were provided from the Investment Property Forum

REITs have been around for many years…

In the United States and Australia, there are well established and significant REIT sectors that offer small private investors access to an asset class they otherwise would not be able to enter. For example, there are now more than 200 quoted REITs in the US. Other countries, including France, Japan and Singapore, have recently introduced REITs.

UK REITs

The UK version of REITs was launched on 1 January 2007. It takes the legal form of a UK company with a special tax status. Most of the UK's larger quoted property companies have converted to REIT status.

Tax benefits—most of the REITs are not taxed on their income or capital gains from investment property

Provided they meet certain conditions, UK REITs are not taxed on their income and capital gains from investment properties. As a result, most of the income and gains can flow directly to shareholders, free of tax. Shareholders are then taxed according to their own circumstances. Distributions from a UK REIT can either be normal company dividends or property income distributions (PIDs), depending on the source of profits from which they arise.

Broadly, PIDs are distributions out of the qualifying tax-exempt property investment activities and are subject to withholding tax at 22%. However, certain overseas investors are entitled to reclaim some of this tax under international double tax treaties. For tax-exempt investors (such as pension funds) and certain specific classes of investors (including ISAs, PEPs and CTFs), PIDs from a REIT are paid gross, without deducting tax at source.

90% of the profits from the property rental business must be paid out to shareholders

Before REITs

This is in contrast to the normal corporate format, under which tax-paying investors in property companies are subject to double taxation. First, the company pays corporation tax on the rental income from its properties and any capital gains arising. Then the investor pays tax on dividends received, with very limited credit for the corporate tax.

The small print

However, to qualify for their special tax status, a UK REIT must meet certain conditions.

- It must be UK tax resident.
- It must be listed on a 'recognised stock exchange', with the shares widely held. (This includes, for example a full LSE listing, but not AIM.)
- It must not be an open-ended company.

There are also further conditions which do not necessarily result in immediate removal from the REIT regime if they are not met.

- It must have a simple share and loan capital structure.

- At least 75% of its income must be from rents and 75% of its assets must be investment properties. Owner-occupied property does not qualify.
- It must hold at least three investment properties, though the definition of property includes separate rental units within one building.
- No single property may represent more than 40% of the total portfolio value.

It is important to note the following:

- Income from non-property investment activities is taxed at the usual corporate rate of 30%.
- Development for investment is allowed.

The definition of property is quite widely drawn. There are no restrictions on the types of real estate that can be included.

The penalties

In addition, REITs will suffer tax penalties if they:

- Pay dividends to corporate shareholders that have a 10% or more direct or indirect shareholding. This is aimed at preventing tax leakage, since substantial shareholders may otherwise be able to reclaim all of the tax withheld at source.
- Allow gross income to be less than 125% of interest.
- Fail to distribute 90% of their income profits from its property investment activities. There is no obligation to distribute capital gains.

The cost of admission

To convert to a REIT, companies must pay an 'entry charge' of 2% of the market value of their investment properties. In return for this up-front payment, UK REITs are effectively able to eliminate any historical contingent capital gains on these properties and reduce their tax liabilities on income and gains going forward.

Figure 59: Comparative table of European REIT regimes

	German REIT	French SIIC	Dutch FBI	UK REIT	Italian SIIQ
Legal form	AG (*stock corporation*) with seat and management in Germany and obligatory listing within EU/EEA.	Any company with a share capital divided into shares. Additional restrictions (not applying to SIIC sub of a SIIC): i) listing in France and ii) minimum share capital of €15 mio.	NV, BV (*limited liability company*) or FGR (*mutual fund*) or a comparable entity within the EU.	Closed ended company, listed on a "recognised" exchange.	Joint Stock Company (Società per Azioni), listed on Italian stock exchange. Company's name must include the words "società d'Investimento Immobiliare Quotata". Minimum share capital of €40 mio.
Investors' requirements	No investor must hold > 10% of voting rights. At least 15% of shares must be held by investors who own less than 3% of voting rights.	No investor or affiliated group of investors may own > 60%. Upon election for SIIC regime 15% of the shares owned by investors with max 2% interest.	Various shareholders' restrictions apply for tax purposes. Simplified restriction apply for listed FBI's.	Must not be a "close" company.	No investor must hold >51% of voting rights. At least 35% of shares must be held by investors owning not more than 1% of voting and dividends right.
Activity test	At least 75% of the assets must comprise real estate which meets the qualifying criteria and at least 75% of gross income must come from letting such real estate assets. Prohibition of real estate trading (= turnover of more than 50% of average real estate holdings within a 5 year period).	(French) real estate; non qualifying activities are allowed to a certain extent, however subject to standard CIT rate.	Only passive investments; project development for own portfolio within a taxable FBI subsidiary	Must have at least 75% of its income and assets in qualifying profit rental business ('PRB'). Development is permitted for investment purposes. Owner occupied property does not count as PRB.	At least 80% of assets and income must comprise of real estate.
Leverage limits	55% of real estate value.	No specific leverage restrictions (however, regular thin capitalisation restrictions impact level of distribution obligations).	60% of fiscal book value properties; 20% for all other investments.	No restriction, but tax charge if finance cover is less than a ratio of 1.25.	No specific restrictions yet (however limitations may be introduced by regulatory provisions).
Distribution obligation	At least 90% of net annual income. 50% of capital gains included.	85% of the net rental income, 50% of capital gains and 100% of dividends from lower-tier SIIC subsidiaries.	Applicable to full profit; however, capital gains neutralised in tax free reserves.	90% of income profits of PRB (after deducting finance costs and capital allowances). No obligation to distribute capital gains.	At least 85% of income of real estate. Tax exemption for capital gain not (yet) implemented.
Tax treatment fund	Full exemption from corporate income tax as well as local trade tax.	Exempt from CIT with respect to qualifying income; regular CIT treatment with respect to non-qualifying income. Additional 20% levy on distributions to 10% or more exempt/low taxed shareholders.	Corporate income tax at a rate of 0%. Capital gains may be added to a tax free reinvestment reserve.	Qualifying income and gains of PRB (UK and indirectly held non-UK) are tax exempt. Charge on development if sold within a 3 year period. Residual business taxed in usual way. Tax charge in REIT if distribution made to corporate shareholder holdings 10% or more.	Exempt from CIT with respect to income derived from rental or leasing activities. Regular CIT-treatment with respect to capital gains.
Treaty application	As the G-REIT is subject to corporate income tax (although at a rate of 0%), in general, the G-REIT can make use of bilateral tax treaties.	In general a SIIC can make use of bilateral tax treaties.	As the FBI is subject to corporate income tax (although at a rate of 0%), in general, the FBI can make use of bilateral tax treaties.	Treaties should apply in the usual way, as REIT is taxable.	Whether the treaty relief and the Parent Subsidiary Directive apply is not clear.
Withholding tax treatment	Dividend distributions are subject to 25% withholding tax (reduced to 15 or 10% under tax treaties).	25% to non-resident shareholders and 0% to resident shareholders (see also extra levy above).	Dividend distributions are subject to 15% withholding tax. Distributions from the reinvestment reserve can be made free from dividend withholding tax.	22% withholding, subject to treaty relief.	20% witholding tax on tax-exempt income, can be reduced to 15% at dividends originating from residential building leases. A credit for Corporate and business shareholders
Conversion charge regime	Until December 31, 2009 only 50% of capital gains which are realized through conversion into G-REIT or a transfer of real estate to a G-REIT are taxable ('*exit tax privilege*'), subject to restrictions.	Latent capital gains are taxed at 16.5% upon election for the regime. Same rate applies to capital gains on sales of properties by standard corporations to SIICs (holding period of 5 years). Reduced rate to sellers extended to December 2008.	No special favourable regime.	Charge of 2% on market value (to allow a step-up in base).	Latent capital gain are taxed at a 20% rate upon election for the regime. Same rate applies to capital gains realised by corporate shareholders contributing property to SIIQs (three years holding period).

This table contains a brief comparison of German, French, Dutch, UK and Italian REIT regimes. This comparison does not go into great technical detail, but rather focuses on the main characteristics. It should not be construed as legal or tax advice.

Source: Loyens & Loeff

Real estate equity valuation

Publicly traded real estate companies tend to be valued differently to the direct property markets, although the underlying assets of these companies are valued using the direct property methods discussed earlier.

The main forms of property equity valuation are:

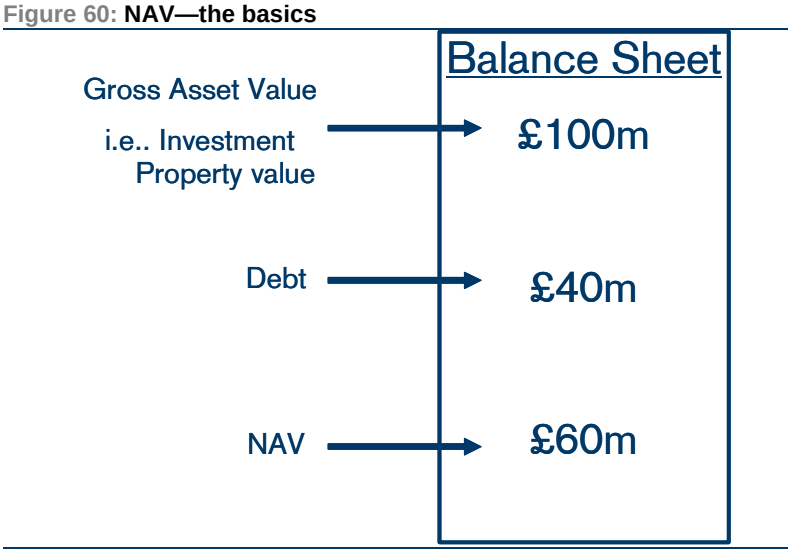
- Discount (or premium) to Net Asset Value (NAV)
- A discounted cash flow
- Funds from operation (FFO) multiple

Net Asset Value

NAV = Total company assets less the total value of its liabilities.

The balance sheets of property companies are centred around investment and development property (the assets) and liabilities (the debt used to purchase/develop property).

Figure 60: NAV—the basics



Source: Credit Suisse research

NAV is expressed on a per share basis and is commonly used in the valuation of shares in the real estate industry where the value of the company originates from the assets it holds rather than the profit stream generated by the business. However, this is slowly changing, with an increased use of DCF methodologies.

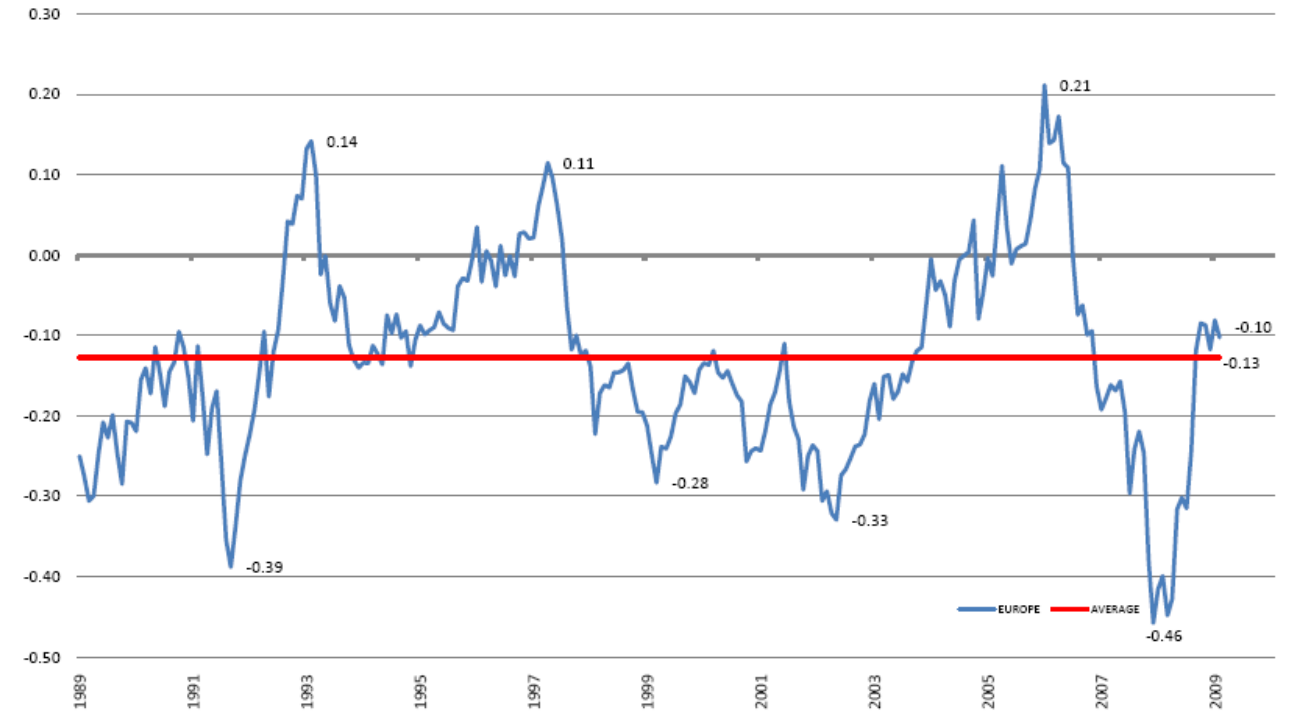
In theory, the quoted share price should not stray far from the share price. However, historically, the companies tend to trade at a discount to their net asset value. We estimate the average long-term discount to NAV is c.10% due to the:

Property companies publish their NAV per share on a semi-annual basis, providing investors and analysts an up-to-date NAV of the business

- Illiquidity of the underlying real estate assets
- Transaction costs
- Risk of tenant defaults
- Increasing real estate management costs

Property companies will often provide an **adjusted diluted NAV** (aka EPRA NAV) for investors. This is the balance sheet net assets plus the surplus on trading properties, excluding fair value adjustments for debt and related derivatives, deferred taxation on revaluations and capital allowances and the effect of those shares potentially issuable under employee share schemes.

Figure 61: **FTSE EPRA/NAREIT index discount to published NAV**



Source: EPRA

The long-term discount to NAV is c.20%, but this is in a pre-REIT environment. In a post-REIT environment, we believe 60% of this discount is closed off due to the elimination of capital gains, providing a 'normal' market discount to NAV of approximately 8–10%.

Funds from operations

FFO is calculated by assessing the net income, adding back non-cash charges such as depreciation. The FFO is often adjusted to take into account capital expenditure for the year.

Figure 62: **Example – FFO**

	Year X
Revenues	**200,000**
Expenses	
Operating Expenses	100,000
Interest Expense	40,000
Annual depreciation	50,000
Total Expenses	190,000
Net Income (Revenue - Expenses)	10,000
Funds From Operations (FFO)	**60,000**
(FFO = Net Income + Depreciation + etc)	

Source: Credit Suisse research

FFO is commonly displayed as a multiple similar to a P/E ratio. It is also commonly interpreted as an EPRA EPS multiple in Europe.

Discounted cash flow

On a stand-alone basis, DCF models can sometimes be quite sensitive; therefore, we work in a strict framework which is the same for all stocks. A DCF model comprises two main parts: (1) cash flow estimates, and (2) a discount rate.

Forecasting cash flows

The first five years are forecast in detail for each stock, including developments and acquisitions once they are announced. Net rental income growth is split into LFLs (indexation plus reversions), the net effect of acquisitions/disposals and/or developments, improvement/deterioration in occupancy rates and, in some cases, the effect of currency fluctuations. For the next five years, we assume LFL growth and, in Klépierre's case (see Figure 63), the delayed impact of a project delivery in 2014 and 7.5% of NRI as continuous capex, while we deduct the NPV of the nominal deferred tax in year 10.

Figure 63: An example: Cash flow forecasts

DCF MODEL (MM/YY)	12/09A	12/10E	12/11E	12/12E	12/13E	12/14E	12/15E	12/16E	12/17E	12/18E	12/19E
Net rental income (NRI)	**796.9**	**822.6**	**879.5**	**925.3**	**970.6**	**1,022.9**	**1,078.0**	**1,110.3**	**1,143.6**	**1,177.9**	**1,213.3**
% Growth		3.2%	6.9%	5.2%	4.9%	5.4%	5.4%	3.0%	3.0%	3.0%	3.0%
LFL (%)		*0.4%*	*2.3%*	*3.0%*	*2.8%*	*2.8%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*
Net Acq/Div. / Developments on stream (%)		*1.6%*	*4.2%*	*2.2%*	*2.0%*	*2.5%*	*1.9%*				
Δ Occupancy / conversion (%)		*0.3%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*					
Currencies		*0.9%*	*0.4%*	*0.0%*	*0.0%*	*0.0%*					
EBIT		**753.9**	**784.2**	**832.2**	**871.6**	**910.5**	**959.6**	**988.3**	**1,018.0**	**1,048.5**	**1,080.0**
Margin (%)		91.7%	89.2%	89.9%	89.8%	89.0%	89.0%	89.0%	89.0%	89.0%	89.0%
Tax rate (%)		2.4%	2.5%	2.5%	2.5%	2.6%	2.6%	2.6%	2.6%	2.6%	4.7%
(-) Taxes on EBIT		-17.9	-19.3	-20.7	-22.0	-23.6	-24.9	-25.6	-26.4	-27.2	-51.0
EBIT*(1-t) or NOPLAT		**736.0**	**764.8**	**811.5**	**849.5**	**886.9**	**934.7**	**962.7**	**991.6**	**1,021.3**	**1,029.0**
(-) Change in working capital		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Cash Flow		**736.0**	**764.8**	**811.5**	**849.5**	**886.9**	**934.7**	**962.7**	**991.6**	**1,021.3**	**1,029.0**
(-) Capital expenditures		-374.4	-205.4	-256.3	-353.1	-288.5	-80.8	-83.3	-85.8	-88.3	-91.0
Operating Free Cash Flow		**361.6**	**559.4**	**555.2**	**496.4**	**598.4**	**853.8**	**879.4**	**905.8**	**933.0**	**938.0**

Source: Credit Suisse estimates

Setting the discount rate

The discount rate or WACC is the result of the weights of the equity and debt within the capital structure. As investment trusts, the companies have stated LT target leverage or equity ratios in their annual reports. Most REITs have set the target leverage ratios between 40–50%, while German residential is more like 50–60% due to the stability of rents and capital values which historically have induced banks to allow for higher leverage.

The cost of debt is based on the company's reporting and benchmarked against current market rates. Credit risk differs per company, and some of the input is subjective, but we typically assume along these lines: (1) the lower the LtV, the lower the risk premium; (2) the bigger the company, the lower the risk premium; and (3) the better quality the portfolio, the lower the risk premium. These conditions apply just as much for equity investors and hence for the cost of equity. Therefore, we monitor if our cost of debt and cost of equity assumptions for each company are compliant with each other and across the sector.

Figure 64: Credit Suisse Real Estate—DCF methodology

Unibail-Rodamco

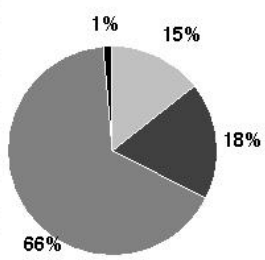
Year ending 31st December — **Figures in €million**

Cash flow yields and mutliples	12/09A	12/10E	12/11E	12/12E	12/13E	12/14E
FFO yield (%)	6.4%	6.5%	7.2%	7.7%	8.3%	8.9%
FFO multiple (x)	15.6	15.5	13.9	13.1	12.0	11.3
Adjusted NAVPS (€)	**12/09A**	**12/10E**	**12/11E**	**12/12E**	**12/13E**	**12/14E**
IFRS NAVPS	124.0	131.2	161.1	170.2	190.5	201.6
Adj. NAVPS[3]	133.7	140.4	168.7	177.2	196.4	207.0
DPS		8.0	16.4	25.3	34.9	45.3
Adj. NAVPS incl. DPS	**133.7**	**148.4**	**185.0**	**202.5**	**231.4**	**252.3**

Target price calculation	
NAVPS 12-month rolling	154
Discount (probability of defaul	1%
NAV component (50%)	152
DCF component (50%)	175
Theoretical target price	**163**

DCF Fair value	
Fair enterprise value	**25,242**
Total PV of cash flows (0-5 years)	3,739
Total PV of cash flows (5-10 years)	4,452
Terminal value	16,782
Associated companies / JVs	270
Fair equity value	**15,950**
Fair enterprise value	25,242
(-) Assumed market value net debt	-8,173
(-) Minority interest	-1,119
(-) Change in equity / Dividends	
Assumed market value net debt	**8,173**
Net debt	7,987
Derivatives	186.1
Preference shares	
Fair value per share (€)	**174.6**
Current share price (€)	**143.8**
Upside / (Downside) from current share price	**21.5%**

Model calculates a discounted value based on an explicit 5-year forecast and a long term growth forecast (5-10 years) less debt and minority interest.



WACC Assumptions (%)	
Cost of Equity at current share price[1]	10.5%
Cost of Equity at Fair value[2]	9.3%
Company Cost of Equity	**9.3%**
Effective cost of debt	4.8%
Tax Rate	1.8%
Company After-tax Cost of Debt	**4.66%**
Debt/Net Assets [D/(D+E)]	40.0%
Equity / Net Assets [E/(D+E)]	60.0%
WACC	**7.42%**
Shares outstanding	91.3
Terminal value	
Free cash flow base	1,668.7
Terminal yield	4.92%
Value	33,948
Discounted	16,782
Long term growth	2.5%

DCF MODEL (MM/YY)	12/09A	12/10E	12/11E	12/12E	12/13E	12/14E	12/15E	12/16E	12/17E	12/18E	12/19E
Net rental income (NRI)	**1,257.3**	**1,286.5**	**1,415.9**	**1,494.7**	**1,597.9**	**1,683.0**	**1,733.5**	**1,785.5**	**1,839.1**	**1,894.2**	**1,951.1**
% Growth		2.3%	10.1%	5.6%	6.9%	5.3%	3.0%	3.0%	3.0%	3.0%	3.0%
LFL (%)		0.8%	3.5%	3.3%	3.4%	3.3%	3.0%	3.0%	3.0%	3.0%	3.0%
Net Acq/Div. & Developments on stream (%)		1.0%	4.6%	1.7%	3.4%	1.9%					
Δ Occupancy / conversion (%)		0.1%	0.6%	0.0%	0.0%	0.0%					
Currencies		0.3%	0.3%	0.0%	0.0%	0.0%					
EBIT		**1,220.5**	**1,339.8**	**1,412.9**	**1,508.4**	**1,587.5**	**1,635.1**	**1,684.1**	**1,734.7**	**1,786.7**	**1,840.3**
Margin (%)		94.9%	94.6%	94.5%	94.4%	94.3%	94.3%	94.3%	94.3%	94.3%	94.3%
Tax rate (%)		1.8%	1.8%	1.9%	1.9%	1.9%	1.9%	1.9%	1.9%	1.9%	3.6%
(-) Taxes on EBIT		-22.2	-24.6	-26.2	-28.4	-30.3	-31.2	-32.2	-33.1	-34.1	-66.0
EBIT*(1-t) or NOPLAT		**1,198.2**	**1,315.1**	**1,386.7**	**1,480.0**	**1,557.1**	**1,603.9**	**1,652.0**	**1,701.5**	**1,752.6**	**1,774.3**
(-) Change in working capital		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Cash Flow		**1,198.2**	**1,315.1**	**1,386.7**	**1,480.0**	**1,557.1**	**1,603.9**	**1,652.0**	**1,701.5**	**1,752.6**	**1,774.3**
(-) Capital expenditures		-1,083.4	-367.1	-319.8	-387.2	0.0	-130.0	-133.9	-137.9	-142.1	-146.3
Operating Free Cash Flow		**114.8**	**948.0**	**1,066.9**	**1,092.8**	**1,557.1**	**1,473.8**	**1,518.1**	**1,563.6**	**1,610.5**	**1,628.0**
WACC		7.4%	7.4%	7.4%	7.4%	7.4%	7.4%	7.4%	7.4%	7.4%	7.4%
(Years discounted)		0.8	1.8	2.8	3.8	4.8	5.8	6.8	7.8	8.8	9.8
Discount factor		0.94	0.88	0.82	0.76	0.71	0.66	0.61	0.57	0.53	0.49
Free Cash Flow from operations		**114.8**	**948.0**	**1066.9**	**1092.8**	**1557.1**	**1473.8**	**1518.1**	**1563.6**	**1610.5**	**1628.0**
PV of Cash Flows		**108.1**	**830.6**	**870.2**	**829.8**	**1100.7**	**969.9**	**930.0**	**891.8**	**855.2**	**804.8**

[1] Share-price implied cost of equity derived from the model. [2] Cost of equity according to our forecast. [3] IFRS NAV plus 70% of Deferred tax provision plus adding back derivatives (BS)

Source: Company data, Credit Suisse estimates

How we calculate our target price

We calculate our target prices as the midpoint between a discounted 12-month forward-looking NAVPS and the fair value derived from our DCF model. This way we capture a balance-sheet-based valuation with a longer-term cash flow one. In addition, we also provide our FFO multiples and yields for the next five years in our standard valuation templates, which are attached at the back of this report.

12-month forward-rolling NAVPS

The benefit of using forward-rolling estimates is that they square out different book year-endings and smooth the changes over time. Furthermore, we believe that investors base their assessments on forward-looking estimates and hence factor the dividend into the NAVPS estimates. We have backtracked the 12-month rolling NAVPS in time and believe that it has been a good indicator for share-price movements.

Discount rate

In our view, the discount rate represents the corporate risk and/or liquidation risk for investors in case of bankruptcy. In the past, we used a 10% discount, which was a rough ballpark figure that we used indiscriminately for all stocks. From now on, we will use a company-specific discount that equals the probability of default as calculated by our HOLT methodology. The POD is stock market implied and could be compared to a CDS spread.

Financial statements

Understanding the financial statements of property companies does not have to be a taxing process, in our view. The two key statements to consider are the balance sheet and the income statement.

- **Balance sheet:** Shows the assets and liabilities and how the business was funded at a specific date in time.

Balance sheet key items:

- Investment properties: Held as an asset on the balance sheet. Investment properties are, in most cases, the highest-value items on a property company's balance sheet. This line item can be very helpful in understanding where companies' underlying property sub-sector exposure lies.

We analyse the notes to the accounts to see what types of properties are included within investment properties: industrial, retail, office, or a mix?

- Debentures/loans/long-term borrowings: Most property companies are reliant on the availability of finance, and this particular line item tends to show just how reliant. The different types of borrowing are stated in the 'Finance' section.

- **Income statement:** aka the Profit and Loss account, it shows the profit or loss made over a period of time.

Income statement key items:

- Rent receivable: Rent received from investment properties. We closely examine where this line item is moving by examining rental growth and the companies' underlying property portfolio. This line item follows the accruals basis, meaning that rent is recognised when payments are made rather when cash is actually received.

- Other income: Some property companies will have property-management businesses where they manage other property or jointly-owned property for a fee. This may include a base fee plus performance-related fees.

- Revaluation of properties: Any increase or decrease of the property portfolio is taken in the income statement, as per accounting standards. In recent years, the revaluation line has seen significant increases as well as decreases.

The cash flow statement records the actual cash movements during the accounting period. Actual cash inflows and outflows are documented in this statement. Items in the cash flow statement can be different from equivalent items in the income statement, as it records cash received; this also tends to make it less susceptible to manipulation.

Figure 65: Example: Balance sheet—British Land

Line items	FY09A	Brief description
	£m	
Assets		
Non-current assets		
Investment properties	5,436	Value of investment properties (includes revaluations/disposals)
Development properties	358	Value of the development portfolio
Owner-occupied property	30	Value of the property currently being occupied by the landlord
	5,824	*Sub-Total*
Other non-current assets		
Investments in funds and joint ventures	952	Group's share of funds and joint ventures (Pillar/Hercules)
Other investments	38	Investments in other companies, which includes listed property company, Songbird Estates Plc
Intangible assets	25	The value of fund management contracts—amortised over the life of the fund
Goodwill	-	Book value of the business (exc. assets/liabilities)
	6,839	*Sub-Total*
Current assets		
Trading properties	-	Under IAS regs, property which is being marketed for sale is a trading asset
Debtors	123	Trade debtors—likely to be tenants who are yet to pay their rent
Cash and short-term deposits	616	Cash/short-term deposits
	739	*Sub-Total*
Total assets	**7,578**	
Liabilities		
Current liabilities		
Short-term borrowings and overdrafts	- 49	Debt which is repayable within one year (or on demand, e.g. overdrafts)
Creditors	- 524	A mixture of trade creditors, accruals and deferred income. A significant proportion will relate to a large number of customers who pay their rental in advance
	- 573	*Sub-Total*
Non-current liabilities		
Debentures and loans	- 3,716	Secured and unsecured debt (maturity >1 year); bonds, debentures, loan notes, loans
Other non-current liabilities	- 45	Immaterial long-term liabilities
Deferred tax liabilities	- 35	Deferred tax treatment; a temporary difference due to change in tax rate
	- 3,796	*Sub-Total*
Total liabilities	- 4,369	
Net assets	**3,209**	**Total Assets - Total Liabilities**
Equity		
Share capital	217	Par value of the share multiplied by the number of shares in issue
Share premium	1,244	Amount paid for equity greater than the nominal value
Other reserves	- 139	Various reserves to include hedging reserve, translation reserve and revaluation reserve
Retained earnings	1,887	Net earning kept by the company (after the dividend is paid)
Total equity attributable to shareholders of the Company	**3,209**	

Source: Credit Suisse research

Figure 66: Example: Income statement—British Land

Line items	FY 2009A	Brief description
	£m	
Rent receivable	462.0	Rent received from investment property—recognised on an accruals basis
Spreading of tenant incentives and guaranteed rent increases	34.0	Incentives amortised across the life of the lease—accounting treatment
Surrender premiums and back rents	1.0	Payments made to BL for the surrender (cancellation) of leases
Service charge income	57.0	Service charges received from tenants (non-profit; to be reversed out)
Gross rental income	**554.0**	***Sub-Total***
Service charge expenses	(57.0)	Service charges used solely for building expenditure—paid back out for services/facilities, e.g. building security
Property operating expenses	(44.0)	Property expenses—e.g. refurbishment, upgrades
Net rental and related income	**453.0**	***Sub-Total***
Pillar FM Base fees	11.0	Base fees received from property fund/management business, Pillar
Pillar FM Performance fees	3.0	Performance fees received from property fund/management business, Pillar
Other income	4.0	
Fees and other income	18.0	*Sub-Total*
Amortisation of intangible asset	(14.0)	Goodwill amortisation as per accounting treatment
Funds and joint ventures	(767.0)	Group's share of results from funds and joint ventures (Hercules/Pillar)
Administrative expenses	(51.0)	
	(832.0)	*Sub-Total*
Net valuation gains (includes profits on disposals)		
-Revaluation of properties	**(3241.0)**	**Revaluation gains/losses taken to the IS—as per accounting standards**
-Gains on property disposals (including trading property appropriations)	0.0	Gains/losses on property disposals
Revaluation and disposals	**(3241.0)**	***Sub-Total***
Net financing costs		
– financing income	52.0	Interest received on deposits and securities
– financing charges	(378.0)	Interest payable on loans/overdrafts
– refinancing charges		
Net financing costs	(326.0)	Sub-Total
Profit on ordinary activities before taxation	(3928.0)	
Taxation		
– REIT conversion charge	0.0	A charge may exist as part of the REIT conversion
– current tax income (expense)	(2.0)	
– deferred tax income (expense)	49.0	Provided-for items that may become taxable at a later date—the difference between the balance sheet value and tax base value
Tax charge	47.0	
Profit for the year after taxation attributable to shareholders of the Company	**(3881.0)**	

Source: Company data, Credit Suisse research

Figure 67: Example: Cash flow statement – British Land

Line items	FY 2009A	Brief description
	£m	
Rental income received from tenants	455.0	Actual cash-rent received
Fees and other income received	30.0	Fees received for property management
Operating expenses paid to suppliers and employees	-79.0	Salaries, wages, property management fees paid
Cash generated from operations	**406.0**	
Interest paid	(270.0)	Interest paid on debt (liabilities)
Interest received	20.0	Interest received on cash/deposits
UK corporation tax paid	16.0	Tax paid
Foreign tax paid	0.0	Tax paid
Distributions received—funds and joint ventures	33.0	Cash received (e.g. rent) from funds and JVs
Net cash inflow from operating activities	**205.0**	***Sub-Total***
Cash flows from investing activities		
Purchase of investment properties and development expenditure	(107.0)	Cash used to purchase property and develop current schemes
Development and other capital expenditure	(436.0)	
Sale of investment properties	904.0	Cash raised from the sale of investment property
REIT conversion charge paid	(6.0)	Cash paid for REIT conversion—one-off item
Indirect taxes in respect of investing activities	3.0	Associated costs alongside investment property, e.g. stamp duty
Establishment of BL Sainsbury Superstores Joint Venture		Cash received to establish JV with Sainsbury
Establishment of Meadowhall JV	115.0	
Purchase of investments		
Sale of investments	2.0	
Investment in and loans to funds and joint ventures	(57.0)	Cash used for investment and loans made to JVs, funds, etc.
Capital distributions received from funds, joint ventures and other investments		Cash received from funds and JVs
Sale of shares and loans repaid by funds and joint ventures		
Purchase of subsidiary companies (net of cash acquired)*		
Net cash (outflow) inflow from investing activities	**418.0**	***Sub-Total***
Cash flows from financing activities		
Issue of ordinary shares	743.0	
Purchase of treasury shares		Cash used for the purchase of treasury shares
Dividends paid	(188.0)	Cash used for the payment of dividends
Repayment of debt acquired with subsidiary undertaking	(11.0)	
Movement in other financial liabilities	(76.0)	
Increase (decrease) in bank and other borrowings	(714.0)	Decrease in borrowings due to the sale of investment properties
Others		
Net cash outflow from financing activities	(246.0)	Sub-Total
Net increase (decrease) in cash and cash equivalents	**377.0**	
Cash and cash equivalents at 1 April	239.0	
Cash and cash equivalents at 31 March	616.0	

Source: Company data, Credit Suisse research

Accounting standards

There are several International Accounting Standards which need to be considered when reviewing the balance sheets of property companies.

Source: International Accounting Standards Board

IAS 40—Investment Property

IAS 23—Borrowing costs

IAS 18—Revenue

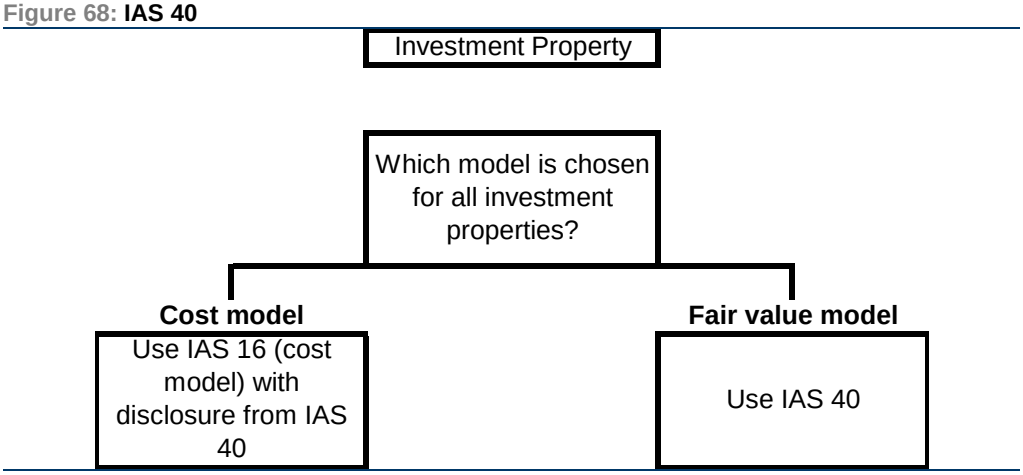
IAS 17—Leases

We highlight the key points in this section with extracts from the International Accounting Standards Committee.

IAS 40—Investment property

IAS 40 relates to the treatment of freehold and leasehold investment property in company accounts.

Figure 68: IAS 40



Source: Credit Suisse estimates

Investment property is property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business.

A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property provided that:

(a) the rest of the definition of investment property is met;

(b) the operating lease is accounted for as if it were a finance lease in accordance with IAS 17 *Leases*; and

(c) the lessee uses the fair value model set out in this Standard for the asset recognised.

Investment property shall be recognised as an asset when, and only when:

(a) it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and

(b) the cost of the investment property can be measured reliably.

As a reminder, property companies value their portfolios independently at least twice a year

An investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement.

Initially held at cost + transaction costs (UK – 5.7525%)

The initial cost of a property interest held under a lease and classified as an investment property shall be as prescribed for a finance lease by paragraph 20 of IAS 17, i.e. the asset shall be recognised at the lower of the fair value of the property and the present value of the minimum lease payments. An equivalent amount shall be recognised as a liability in accordance with that same paragraph.

The Standard permits entities to choose either:

(a) a fair value model, under which an investment property is measured, after initial measurement, at fair value with changes in fair value recognised in profit or loss; or

You have two choices; Fair Value or at Cost

(b) a cost model. The cost model is specified in IAS 16 and requires an investment property to be measured after initial measurement at depreciated cost (less any accumulated impairment losses). An entity that chooses the cost model discloses the fair value of its investment property.

The fair value of investment property is the price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Therefore, even if the seller is a "forced seller", it does not mean the property is valued on a forced basis

An investment property shall be derecognised (eliminated from the balance sheet) on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.

Gains or losses arising from the retirement or disposal of investment property shall be determined as the difference between the net disposal proceeds and the carrying amount of the asset and shall be recognised in profit or loss (unless IAS 17 requires otherwise on a sale and leaseback) in the period of the retirement or disposal.

IAS 23 – Borrowing costs

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense.

Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds.

Recognition

An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.

A *qualifying asset* is an asset that necessarily takes a substantial period of time to be ready for its intended use or sale.

Developments tend to take a "substantial period of time" to complete…

To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset.

The capitalisation rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period.

An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

(a) it incurs expenditures for the asset;

(b) it incurs borrowing costs; and

(c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

An entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Disclosure

An entity shall disclose:

(a) the amount of borrowing costs capitalised during the period; and

(b) the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

IAS 18 – Revenue

The primary issue in accounting for revenue is determining when to recognise revenue.

Revenue is recognised when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably. This Standard identifies the circumstances in which these criteria will be met and, therefore, revenue will be recognised. It also provides practical guidance on the application of these criteria.

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

This Standard shall be applied in accounting for revenue arising from the following transactions and events:

Rental income would be categorised under 'revenue'

(a) the sale of goods;

(b) the rendering of services; and

(c) the use by others of entity assets yielding interest, royalties and dividends.

Recognition

The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction.

For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed.

Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.

For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.

Revenue shall be measured at the fair value of the consideration received or receivable. *Fair value* is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

The amount of revenue arising on a transaction is usually determined by agreement between the entity and the buyer or user of the asset. It is measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity.

Revenue needs to be adjusted to consider any inducements, e.g. rent free periods which are common in most property sub-sectors

Sale of goods

Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:

(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;

(b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;

(c) the amount of revenue can be measured reliably;

(d) it is probable that the economic benefits associated with the transaction will flow to the entity; and

(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

Rendering of services

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

All in the lease agreement

(a) the amount of revenue can be measured reliably;

(b) it is probable that the economic benefits associated with the transaction will flow to the entity;

(c) the stage of completion of the transaction at the end of the reporting period can be measured reliably; and

(d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method. Under this method, revenue is recognised in the accounting periods in which the services are rendered. The recognition of revenue on this basis provides useful information on the extent of service activity and performance during a period.

When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue shall be recognised only to the extent of the expenses recognised that are recoverable.

Interest, royalties and dividends

Revenue shall be recognised on the following bases:

(a) interest shall be recognised using the effective interest method as set out in IAS 39, paragraphs 9 and AG5–AG8;

(b) royalties shall be recognised on an accrual basis in accordance with the substance of the relevant agreement; and

(c) dividends shall be recognised when the shareholder's right to receive payment is established.

IAS 17 - Leases

The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosure to apply in relation to leases.

The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

Operating Leases

Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Finance Leases

At the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities in their balance sheets at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Any initial direct costs of the lessee are added to the amount recognised as an asset.

Minimum lease payments shall be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge shall be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability. Contingent rents shall be charged as expenses in the periods in which they are incurred.

A finance lease gives rise to depreciation expense for depreciable assets as well as finance expense for each accounting period. The depreciation policy for depreciable leased assets shall be consistent with that for depreciable assets that are owned, and the depreciation recognised shall be calculated in accordance with IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset shall be fully depreciated over the shorter of the lease term and its useful life.

Operating Leases

Lessors shall present assets subject to operating leases in their statements of financial position according to the nature of the asset. The depreciation policy for depreciable leased assets shall be consistent with the lessor's normal depreciation policy for similar assets, and depreciation shall be calculated in accordance with IAS 16 and IAS 38. Lease income from operating leases shall be recognised in income on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished

Finance Leases

Lessors shall recognise assets held under a finance lease in their statements of financial position and present them as a receivable at an amount equal to the net investment in the lease. The recognition of finance income shall be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease.

Manufacturer or dealer lessors shall recognise selling profit or loss in the period, in accordance with the policy followed by the entity for outright sales. If artificially low rates of interest are quoted, selling profit shall be restricted to that which would apply if a market rate of interest were charged. Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease shall be recognised as an expense when the selling profit is recognised.

Sale and leaseback transactions

A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset. The lease payment and the sale price are usually interdependent because they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

Performance management / Benchmarking

Benchmarking property performance has proved difficult across Europe due a lack of reliable and consistent information. However, services such as Investment Property Databank ('IPD') are changing this. IPD is widely considered to be one of the leading market data sources and assists property companies in benchmarking performance with a reliable and independent databank.

Investment Property Databank (IPD)

IPD is the yardstick for commercial property investors to measure the returns they achieve on their real estate and compare its performance. This is provided by an independent research company, IPD, which is known to produce objective, reliable property benchmarks and indices for a number of countries globally.

Property performance is not measured on the basis of transaction data but are based on records from the portfolio valuations of leading property agents in the country of operation as well as a number of property funds.

IPD's annual database is considered to be the most comprehensive benchmark of direct property performance in the UK. It monitors c.50% of the UK investment market. Quarterly and Monthly indices are also available; however, they cover a smaller proportion of the property market.

The monthly index provides a fast-moving indicator of current market conditions covering 15% of the UK investment market, but differs in composition from the annual index in that it contains, for example, few large portfolios and fewer higher-value assets, such as shopping centres and central London offices.

IPD provides the following data across the retail, industrial and office markets:

- Income return
- Capital growth
- Total return
- ERV growth
- Initial yield
- Equivalent yield

IPD is predominantly used in the UK as its records go back to the 1980s. However, its data history is much shorter in international markets. IPD returns are used in the UK by direct property and indirect property owners (e.g. REITs) as a benchmark for performance.

All the companies in our coverage universe subscribe to the performance measurement service provided by IPD. Disclosure of this detailed performance measurement is however highly selective, whereas we consider such performance benchmarking and its disclosure to be essential for shareholders for a variety of reasons:

- Fund managers derive performance fees subject to outperforming the benchmark;
- Performance-related pay is often contingent upon performance relative to IPD;
- Measures are selectively used in reports & accounts and investor presentations;
- Details are provided highlighting managements' ability to generate relative out/underperformance in property.

Performance targets — performance fees based on IPD benchmarks

In addition to base management fees that are typically charged within a bandwidth of 25–75bps of property assets under management, property fund managers may also generate, subject to relative total property return performance, additional performance-related fees. Typically, such fees will be based on a three-year performance history, with a claw-back provision relative to a specific IPD benchmark.

For example, British Land Fund Management can receive performance fees based on its performance relative to IPD for the Hercules Unit Trust (HUT) and the Hercules Income Fund (HIF). The performance fee for HUT is 20% above the hurdle of the total return generated by IPD's retail warehouse indices +1% and HIF's is 20% above IPD's total return for its retail warehouse. Measurement is over a three-year period with claw-back provision. Performance fees of £17m were recognised during FY07, £16m relating to HUT and £1m for HIF. Performance fees for Capital and Regional's Mall and Junction funds require similar outperformance relative to IPD's shopping centre and retail warehouse indices.

European Public Real Estate Association (EPRA)

EPRA is a common interest group, established as a non-profit body representing publicly traded real estate companies in Europe. EPRA's mission statement is "to promote, develop and represent the European public real estate sector".

EPRA's stated aim is to establish best practices in;

- Accounting
- Company reporting
- Corporate governance
- Investor information
- Create a framework for debate and decision making on future sector issues

EPRA provides a monthly statistics bulletin, which covers:

- European real estate sector performance benchmarked globally
- Country dividend yields / performance
- Company stock performance

Long-term incentive plans (LTIPs)

LTIPs have existed in the corporate world for some time with executives earning a basic salary alongside the opportunity to capture a LTIP awarded in the form of shares that are then subject to performance benchmarking over a three-year period.

Remuneration committees have defined a wide variety of both performance measures and hurdle rates for such LTIPs to crystallise. Some are easier to attain than others.

The LTIP will usually consist of either (i) market value options or (ii) performance shares.

Performance indicators include:

- Total return (share price and NAV based) relative to property majors and relevant indices;
- Property returns relative to Investment Property Databank;
- Rental growth from reviews and new lettings relative to ERV and sector norms;
- Operating costs as a percentage of rents and assets against prior-year and property majors;
- Underlying EPS relative to prior year, to forecast and to other property majors.

Credit Suisse HOLT® Real Estate Model (HOLT REM)

A Total System Approach to Valuing Real Estate Firms

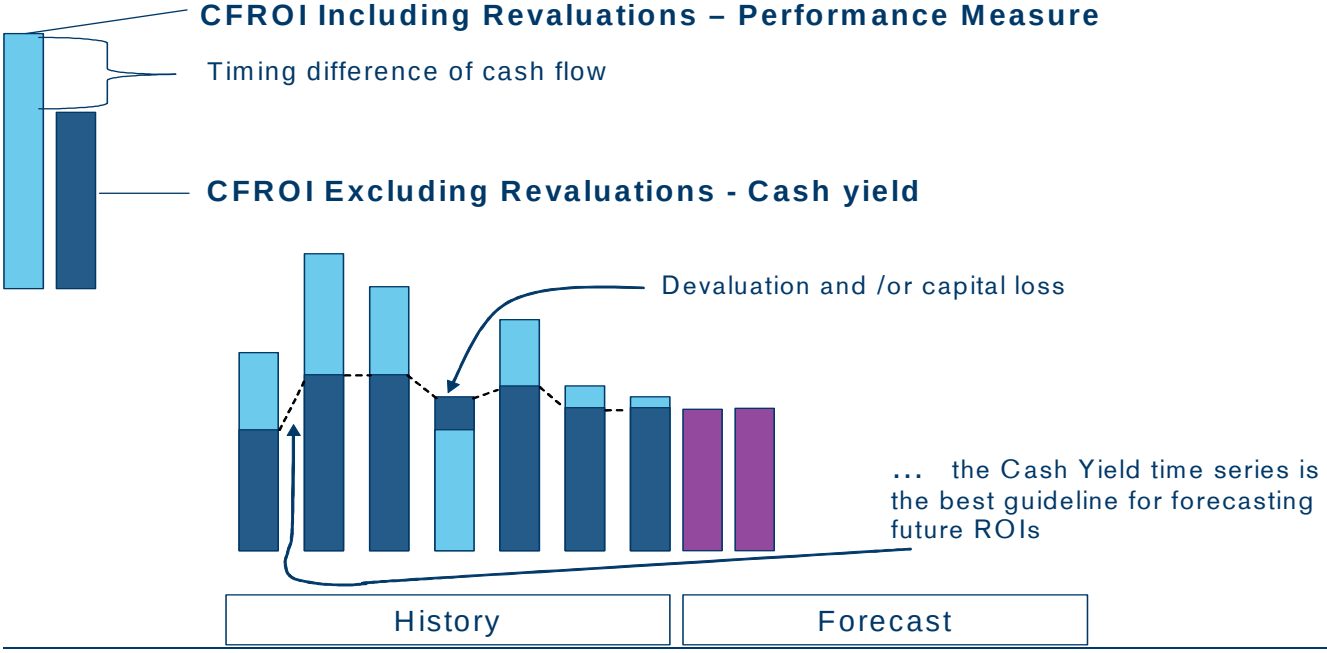
In our view, and as seen in practice, a valuation of REITs should include, if not prioritise, a cash flow–based methodology. To put it simply, this means that if the underlying asset base (property portfolio) is not liquidated, a REIT distributes in perpetuity all of its cash flow profits. Therefore, a REIT analyst typically uses the following valuation methods: Dividend Discount Model (DDM), Gordon Growth Model (GGM) and various discounted cash flows including Economic Value Added (EVA).

HOLT is a Credit Suisse–owned proprietary performance measurement and valuation framework with a track-record of analysing and forecasting securities using a Cash Flow Return on Investment measure (CFROI®) across a global universe. The Credit Suisse HOLT Real Estate Model (HOLT REM) takes a CFROI® approach to real estate valuation.

HOLT REM replicates real estate project economies and tracks performance and screens

HOLT REM provides a robust and reliable measure for analysing, valuing and deciphering market expectations for real estate firms globally. Revaluations are taken into account to correctly reflect the underlying economics CFROI® (Cash Yield), see Figure 69, and the CFROI including revaluations. In our view, this provides the most insightful real estate specific measure of value creation and therefore ultimately performance.

Figure 69: HOLT Relative Wealth chart

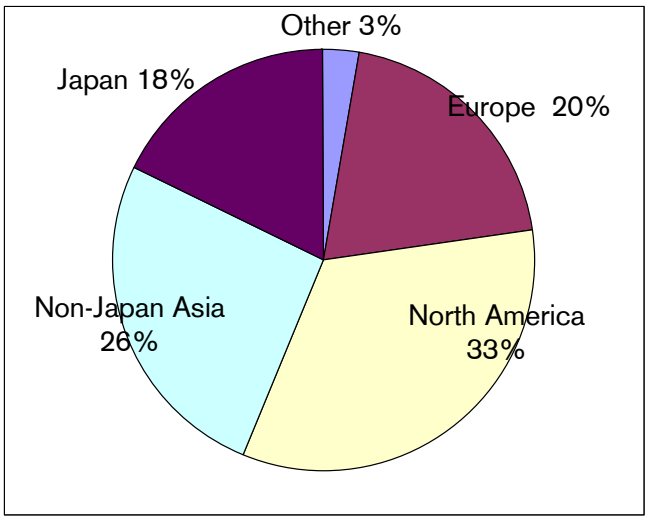


Source: Credit Suisse HOLT

The HOLT REM database has a line-up of 950 real estate companies

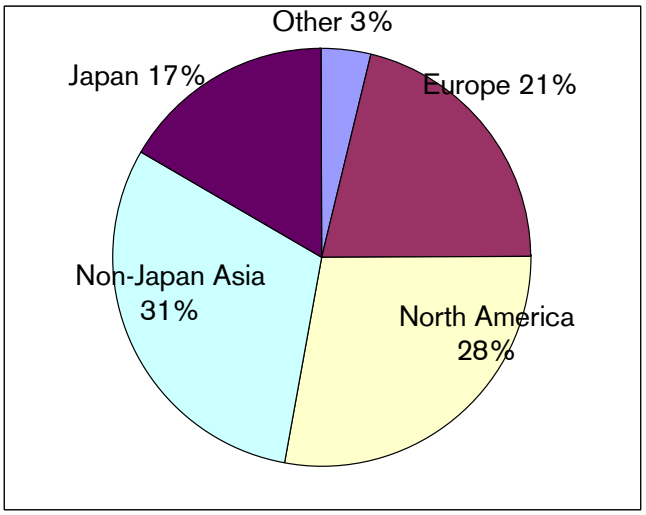
HOLT REM currently has a total of 950 real estate companies in its database (*ValueSearch*^{TM}). This provides the user with multiple screening capabilities and also provides an array of valuation and/or financial ratios to aid decision making for portfolio managers across multiple jurisdictions and real estate sub-sectors.

Figure 70: Regional breakdown by market capitalisation



Source: Credit Suisse HOLT

Figure 71: Regional breakdown by number of companies



Source: Credit Suisse HOLT

The HOLT REM Framework

Determining the Cash Yield – a good proxy for rental yield on the underlying portfolio

In summary, HOLT REM provides a default warranted valuation using an estimated future Cash Yield applied to a marked-to-market investment base and discounting back at an implied market cost of capital. The cash yield is faded to a long-term rate that matches its long-term cost of capital, thereby capping a growth-in-perpetuity outcome. In practice, for real estate companies this convergence typically happens in 25 years.

Figure 72: Revalued (inflation adjusted) asset base

Net Working Capital
+ Investment Properties (revalued)
+ Development Properties (revalued)
+ Trading Properties (revalued)
+ **Other Gross Assets** (Inflation Adjusted)
+ Other Assets less Pension Assets
= Inflation Adjusted Gross Investment

= **Revalued Asset Base**

Source: Credit Suisse HOLT

Figure 73: Gross cash flow excluding property revaluations

Net Income
- Special Items
- Gains /(Losses) on disposal of assets
- Revaluations Recognised Directly (RRD)
- Equity Investment Income
= **Base rent related Income**
+ depreciation
+ Interest Expense
+ Rent Expense
+ Other Adjustments
= **Total Gross Cash Flow excluding revaluations**

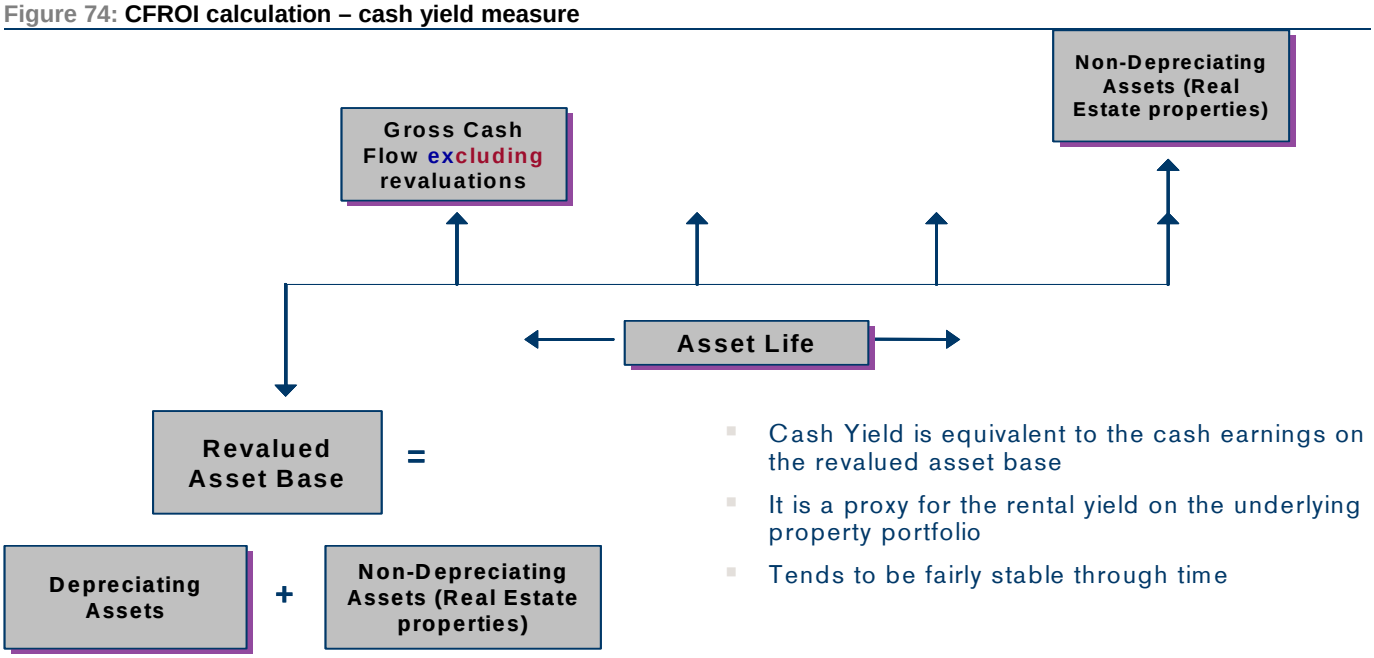
= **Gross Cash Flow excluding revaluations**

Source: Credit Suisse HOLT

Cash yield is equivalent to adjusted earnings providing a proxy for the recurring (underlying) earnings of the real estate company

Gross Cash Flows are discounted back to provide the Cash Yield on the (inflation) revalued asset base. The Cash Yield is equivalent to the cash earnings (adjusted earnings under EPRA/IFRS guidelines) and provides a proxy for the recurring earnings of the real estate company.

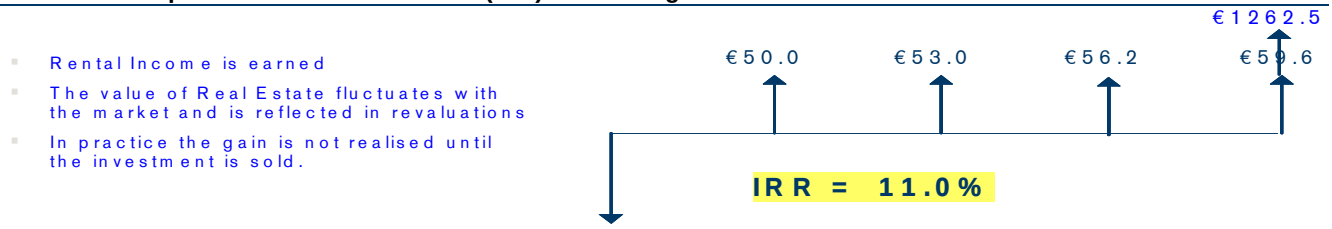
Figure 74: **CFROI calculation – cash yield measure**



Source: Credit Suisse HOLT

Note: In determining the Gross Cash Flow (inc. revaluations) both investment and development portfolio gains/losses, and the disposal of assets are added back.

Figure 75: A example of return on investment (ROI) from a single asset



Year	0	1	2	3	4
Investment	-€1,000.0				€1262.5
Revalued Asset Base		€1060.0	€1123.6	€1191.0	€1262.5
Asset Appreciation		€60.0	€63.6	€67.4	€71.5
Operating Cash Flow		€50.0	€53.0	€56.2	€59.6
Gross Cash Flow		€110.0	€116.6	€123.6	€131.0
Cash yield %		5%	5%	5%	5%
ROI %		11%	11%	11%	11%
ROI historic assets %		5.0%	5.3%	5.6%	32.2%

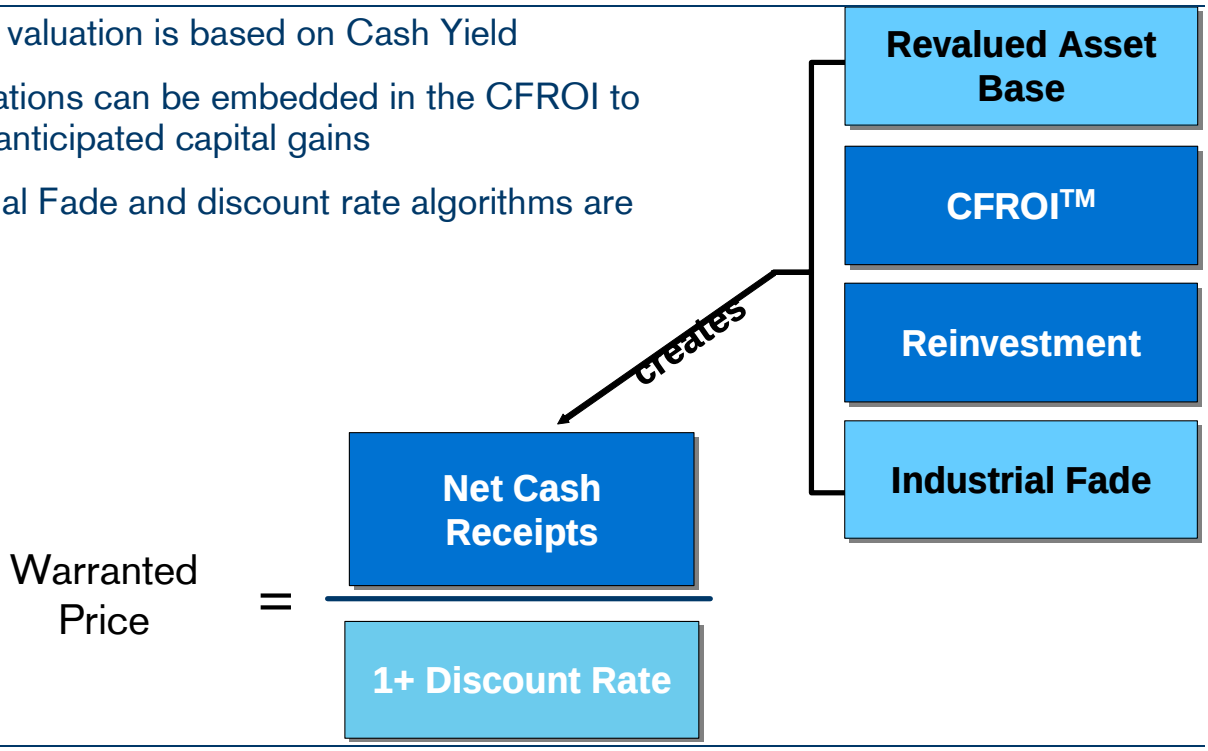
Source: Credit Suisse HOLT

Warranted Price – using a top-down or bottom-up approach

Once the Gross Cash Flow, Cash Yield and Revalued asset base has been determined, the Warranted Price for a given real estate stock can be calculated (see Figure 76).

Figure 76: Illustration of Warranted Price determination of a real estate stock

- Default valuation is based on Cash Yield
- Revaluations can be embedded in the CFROI to reflect anticipated capital gains
- Industrial Fade and discount rate algorithms are applied



Source: Credit Suisse HOLT

The HOLT REM also allows users to input their own 'views of the world' in terms of cash-yield trends underlying asset growth and likely asset appreciation/depreciation patterns. This can be done on a company-by-company basis, or across a selected user-defined universe.

EPRA Best Practice Policy recommendations

Source: EPRA best practice policy recommendations – May 2008

The European Public Real Estate Association (EPRA) provides the following guidance to maintain consistency in company reporting across the European listed property market.

EPRA is neither an accounting body nor a valuation body. EPRA members report in accordance with International Financial Reporting Standards (IFRS). The Best Practices Recommendations provide a framework for:

- Specific additional guidance for real estate companies within the IFRS framework;
- Uniform performance reporting and presentation between real estate companies;
- Additional disclosure guidance.

Net Asset Value and Earnings Per Share

The introduction of IFRS has resulted in substantial changes to reported profits and net assets for real estate investment companies. Companies across Europe have begun reporting their results under IFRS, and many are making various adjustments to the IFRS GAAP measures for EPS and NAV/share to help explain their performance to investors and analysts.

The EPRA best practice financial reporting committee has always considered consistency and comparability in performance reporting measures to be of utmost importance. A Pan-European working group was established to prepare a best practice recommendation for EPRA members on the use of adjusted NAV per share and EPS measures and guidance on the nature of potential adjustments during this transitional period to IFRS reporting. The working group has therefore provided guidance on an adjusted EPS and NAV per share.

EPS

Diluted EPRA EPS represents the earnings from the core operational activities. Therefore it excludes any revaluation results and results from sales of investment properties. The diluted EPRA EPS should reflect the actual business model of the company in the schedule given in Figure 77 as a true real estate investment company. However, should real estate trading be part of the core business, the related results would remain in the P&L.

The intention is that the adjustments would be audited so that the EPRA measures of earnings and net asset value per share have credibility with investors.

Figure 77: EPS

		Earnings in thousounds euro	Earnings per share * euro
Diluted earnings per IFRS income statement		**30,500**	**30.20**
i)	Revaluation movement on investment properties, development properties held for investment and other investment interests	-26,140	-25.88
ii)	Profits or losses on disposal of investment properties, development properties held for investment and other non current and current investment interests. **	-540	-0.53
iii)	Tax on profits or losses on disposals ***	135	0.13
iv)	Negative goodwill / goodwill impairment	-	-
v)	Movement in fair value of financial instruments	-140	-0.14
vi)	Deferred tax ****	3,400	3.37
vii)	Minority interests in respect of the above *****	47	0.05
Diluted EPRA EPS		**7,262**	**7.19**

*) Average number of diluted shares used is 1,010
**) Comprise both investment property and held for trading in example p/l
***) In this example, percentage used is 25% x 540 = 135
****) Total tax expense in profit and loss 3,800, comprises 3,400 deferred tax expense and 400 current tax expense"
*****) In this example, percentage used is 0.2% x (26,140+540-135+140-3,400) = 47

The adjustments i to vi are the required adjustments to determine Diluted EPRA EPS. Other adjustments could be necessary should the company's business model so require.

Source: EPRA

EPS: Adjustments

(i) *Revaluation movement on investment properties, development properties held for investment and other investment interests*

The surplus or deficit in the profit and loss account arising in the period from the revaluation of investment properties, development properties held for investment purposes and other investment interests held as non-current assets at their fair value.

(ii) *Profits or losses on the disposal of investment properties, development properties held for investment purposes and other non-current and current investment interests*

The profit or loss on disposal of investment properties, development properties held for investment and other non-current investment interests, calculated with reference to the carrying value at the date of the balance sheet at the beginning of the financial year, and after deducting capex incurred over the period and the costs of sale.

(iii) *Tax on profits or losses on disposals*

The tax charge or credit relating to profits or losses on investment properties, development properties and other investments sold in the period, calculated consistently with (ii) above.

(iv) *Negative goodwill / goodwill impairment*

The excess of the fair value of assets acquired over their cost of acquisition, which IFRS requires to be recognised immediately in the income statement, together with any impairment charges in respect of positive goodwill and amortisation of intangibles.

(v) *Movement in fair value of financial instruments*

The surplus or deficit arising in the period from the marking to market of financial instruments that are economically effective hedges but do not qualify for hedge accounting under IFRS, including related foreign exchange differences.

To include any adjustment under this heading, Boards must explain their hedging strategy in sufficient detail, and give sufficient disclosure, for readers of the accounts to understand why the financial instruments are economically effective hedges. A description of how the Board measures the effectiveness should also be disclosed.

(vi) *Deferred tax*

The deferred tax charge or credit in the period which relates to the above items, and which would not crystallise until or unless the property, investment or financial instrument is sold. This would typically include deferred tax on revaluation surpluses and tax depreciation (in the UK capital allowances) on real estate that could reverse on disposal of the asset.

NAV

Diluted EPRA NAV represents fair value of equity on a long-term basis. Items that have no impact on the company long term, such as fair value of derivatives and deferred taxes on property fair values, are therefore excluded.

Figure 78: NAV

		NAV in thousands - euros	Shares	NAV per share - euro
NAV per the financial statements		**129,740**	**1,000**	**129.74**
Effect of exercise of options, convertibles and other equity interests		1,305	10	n/a
Diluted NAV, after the exercise of options, convertibles and other equity interests		**131,045**	**1,010**	**129.75**
(i.a)	Revaluation of investment properties (if IAS 40 cost option is used)	-	-	
(i.b)	Development properties held for investment *	1,860		1.84
(i.c)	Revaluation of other non current investments	-		-
(ii)	Fair value of tenant leases held as finance leases **	15		0.01
(iii)	Fair value of trading properties ***	2		0
(iv)	Fair value of financial instruments ****	540		0.53
(v.a)	Deferred tax (net of asset 360 and liability 11,540)	11,180		11.07
(v.b)	Goodwill as result of deferred tax	-		-
Diluted EPRA NAV		**144,642**		**143.21**

*)	Difference between development property in balance sheet at cost 4,660 and fair value development property 6,520
**)	Difference between finance lease receivables in balance sheet at amortised cost 120 and fair value finance lease receivables 135
***)	Difference between trading properties in balance sheet at cost (IAS 2) 500 and fair value of trading properties 502
****)	Net of derivative assets 20 and liabilities 560 stated in balance sheet

Source: EPRA

NAV: Adjustments

(i) *Revaluation to fair value of investment properties, development properties held for investment and other non-current investments.*

If the option under IAS 40 has been taken into account for investment properties at cost, this adjustment includes the revaluation of the asset to fair value in accordance with the valuation option under IAS 40.

The valuation increase/decrease to fair value of any non-current development properties held at cost under IAS16.

The valuation increase/decrease to fair value of any other non-current investment where fair value can be reliably determined. The basis of valuation will need to be disclosed.

(ii) *Fair value of tenant leases held as finance leases*

The surplus or deficit arising on the revaluation to market value of tenant leases that are accounted for as finance leases.

(iii) *Fair value of trading properties*

The surplus, arising on the revaluation to market value of properties held for trading, is included in the IFRS balance sheet, at the lower of cost and net realisable value.

(iv) *Fair value of financial instruments*

Excludes the net mark-to-market adjustment to the value of financial instruments that are economically effective hedges, and are required to be included as assets or liabilities in the IFRS balance sheet. The determination and disclosure of financial instruments, considered to be economic hedges but not qualifying for hedge accounting under IAS 39, are as per adjustment (v) for EPRA EPS above.

(v) *Deferred tax*

(a) No deferred tax is provided in respect of the revaluation of investment property, development property held for investment or other non-current investments, as this would only become payable if the assets were sold. Deferred tax in respect of these items are deducted in arriving at the 'triple net NAV' (see Figure 79). Any deferred tax in the balance sheet in respect of these items, calculated in accordance with IAS 12, should therefore be added back in, arriving at the EPRA NAV.

The deferred tax liability relating to the above items (iii) and (iv), which would not crystallise until or unless the property or financial instrument, is sold should be added back.

Any deferred tax relating to property depreciation allowances (in the UK capital allowances) that could reverse on disposal of the property should be excluded.

(b) Where goodwill is included on the balance sheet as the result of a deferred tax liability that is eliminated as a result of this adjustment, the goodwill should be excluded.

Triple Net Asset Value

Diluted EPRA NNNAV represents fair value of equity and includes fair value adjustments of all material balance-sheet items that are not reported at their fair value as part of the NAV per the IFRS balance sheet statement.

Figure 79: Triple NAV (NNNAV)

		NAV in thousands - euro	Shares	NAV per share - euro
	Diluted EPRA NAV	**144,642**	**1,010**	**143.21**
(i)	Fair value of financial instruments	-540		-0.53
(ii)	Fair value of debt *)	360		0.36
(iii)	Deferred tax **)	-6080		-6.02
	Diluted EPRA NNNAV	**138,382**		**137.01**

Source: Company data, Credit Suisse estimates

NNNAV: Adjustments

(i) Fair value of financial instruments

This reinstates, and is equal to, the adjustment B (iv) being the fair value of financial instruments considered to be economic hedges but not qualifying as hedges under IAS 39.

(ii) Fair value of debt

A mark to market adjustment, measured in accordance with IAS 39 in respect of all debt not held on the balance sheet at its fair value.

(iii) Deferred tax

Provision for deferred tax in respect of the latent capital gains tax, or similar according to each country's tax rules, arising on the revaluation of investment and development properties and other investments to market value. In calculating the deferred tax, consideration should be given to the market norm in which properties are disposed of and the related tax rules.

For example, in some countries properties are purchased and sold directly, and in others, via the sale of shares in a corporate vehicle that owns the property. Where there is no predominant form of sale, deferred tax should be calculated assuming the higher tax rate.

Deferred tax should be provided in respect of tax depreciation allowances (in the UK capital allowances) that potentially become payable on the disposal of investment property.

The fair value of the deferred tax is the company's assessment, and is based on the expected realisation of the underlying assets and liabilities. Discounting is a common method to come to an approximation of the fair value based on the average expected holding period and manner of realisation.

Glossary

Deferred capital gains tax

Source: EPRA

- Capital gains tax that would be realised upon the sale of assets, on a non-discounted basis.

Development property

- Property under development for the purpose of inclusion in investment property at completion.

Development property held for sale

- Property under development for the purpose of sale.

Development surplus

- The excess, if any, between fair value and total development cost.

Effective ERV (EERV)

- ERV including the net effects of lease incentives.

Estimated rental value (ERV)

- The estimated market rental value of lettable space, being passing rent plus vacancy loss and under rented loss and less over-rent gain.

Estimate to complete (ETC)

- Costs still to be expended on a development or redevelopment to practical completion (not to complete letting), including attributable interest.

Gross current yield

- The passing rent divided by the fair value of the portfolio or of the property.

Gross initial yield

- The passing rent at acquisition date or subsequent reporting date divided by cost of acquisition (including all transaction costs).

Gross rental income

- Contractual rental income for the period from let properties, after taking into account the net effects of straightlining for lease incentives.

Gross yield

- Gross rental income of the year divided by fair value.

Initial reversionary yield

- Market rent on occupied space divided by cost of acquisition (including all transaction costs).

Lease incentive

- Any consideration or expense leading to a reduction in income in order to secure a lease.

Lettable space

- Any part of a property that can be leased to a tenant.

Like-for-like

- Comparable information relating to elements that existed for the whole of the current and prior-year period.

Market rent

- The estimated amount for which a property, or space within a property, should lease on the date of valuation between a willing lessor and a willing lessee on appropriate terms in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.

Market value

- The estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.

Net current yield

- Passing rent less property operating expenses at last reporting date divided by the fair value of the portfolio or of the property.

Net initial yield

- The passing rent less property operating expenses divided by cost of acquisition (including all transaction costs).

Net rental income

- Gross rental income plus/less: interest received on finance lease assets, ground rents paid, service charge expenses and income on principal basis and property operating expenses.

Net yield

- Net rental income of the year divided by fair value.

Over-rented space

- Space that is let at a passing rent above its estimated rental value.

Over-rent gain

- The amount by which the passing rent exceeds the market rent.

Passing rent

- The annual gross rental income as per a certain date, excluding the net effects of straightlining for lease incentives.

Pre-let

- A lease signed with an occupier prior to completion of a development.

Property operating expenses

- The expenses directly relating to a property for a certain period of time for the account of the landlord including service charges not recoverable because of vacancy.

Prospective rental income

- Passing rent plus reversion to take place in the next financial period.

Redevelopments

- Existing investment properties being redeveloped, intended to be used for continued future use as investment property.

Reversion

- The estimated change in rent at review based on today's market rents expressed as a percentage of passing rent at review.

Service charge expenses

- The amounts paid and/or accrued by the landlord relating to lettable space for which it has been agreed with tenants to recover these amounts from the tenants periodically.

Service charge income

- The amounts received and/or accrued by the landlord in respect of service charge expenses.

Tenant investments

- The refurbishment expenses to (re)let vacant space, to relet space becoming vacant at the expiry date of a lease or to renew a lease which amount is amortised over the term of the lease.

Terminal capitalisation rate

- Rate used to convert income into an indication of the anticipated value of the property at the end of the holding period.

Theoretical rent

- Gross rental income plus the effective ERV applied to vacant space (voids) over the reporting period.

Total development cost

- All capex on a development project including the opening book value of the property on commencement of development, including attributable interest and other costs.

Trading property

- Property held with the intention to sell.

Turnover rent

- Any element of rent (to be) received related to the turnover of a tenant.

Under-rented space

- Space where the passing rent is below the estimated rental value.

Under-rent loss

- The amount by which the market rent exceeds the passing rent

Vacancy loss at reporting date

- The effective estimated rental value for the total of vacant space at the reporting date

Vacancy loss for the reporting period

- The estimated market rental value for the total of vacant space for the reporting period

Vacancy rate at reporting date

- The vacancy loss expressed as a percentage of the effective estimated rental value for the lettable space of the portfolio at the reporting date.

Vacancy rate for the reporting period

- The vacancy loss for the reporting period expressed as a percentage of theoretical rent.

Vacant space

- Unrented lettable space

Valuation gains

- The increase in the value of investment property on reporting date compared with the previous reporting date, less capex.

Valuation losses

- The decrease in the value of investment property on reporting date compared with the previous reporting date, less capex.

Value of developments on completion

- Calculation in today's terms of developments if they were complete assuming current rental values and yields.

Void

- Vacant space.

References / Further reading

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Property agents	
Jones Lang LaSalle	www.jll.com
CB Richard Ellis	www.cbre.com
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Savills	www.savills.com
Knight Frank	www.knightfrank.com
Industry bodies	
British Property Federation	www.bpf.org.uk
Investment Property Forum	www.ipf.org.uk
Royal Institute of Chartered Surveyors	www.rics.org.uk
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Property Week	www.propertyweek.co.uk
Estates Gazette online	www.egi.co.uk
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BusinessImmo	www.businessimmo.com
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Accounting standards	
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Companies Mentioned *(Price as of 31 Mar 10)*
Alstria Office REIT-AG (AOXG.DE, Eu8.40, NEUTRAL [V], TP Eu9.00, MARKET WEIGHT)
Befimmo (BEFB.BR, Eu62.21, UNDERPERFORM, TP Eu64.00, MARKET WEIGHT)
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Derwent London (DLN.L, 1366.00 p, NEUTRAL [V], TP 1229.00 p, MARKET WEIGHT)
Deutsche Euroshop (DEQGn.DE, Eu24.32, OUTPERFORM, TP Eu27.00, MARKET WEIGHT)
Deutsche Wohnen (DWNG.DE, Eu7.51, OUTPERFORM [V], TP Eu9.00, MARKET WEIGHT)
Eurocommercial Properties (SIPFc.AS, Eu29.75, OUTPERFORM, TP Eu34.00, MARKET WEIGHT)
Gagfah (GFJG.DE, Eu6.62, NEUTRAL [V], TP Eu7.00, MARKET WEIGHT)
Hammerson Property (HMSO.L, 393.40 p, NEUTRAL [V], TP 423.00 p, MARKET WEIGHT)
ICADE (ICAD.PA, Eu82.41, OUTPERFORM, TP Eu69.40, MARKET WEIGHT)
Klepierre (LOIM.PA, Eu29.08, NEUTRAL [V], TP Eu31.00, MARKET WEIGHT)
Land Securities (LAND.L, 678.00 p, NEUTRAL [V], TP 707.00 p, MARKET WEIGHT)
Liberty International (LII.L, 503.50 p, UNDERPERFORM [V], TP 444.00 p, MARKET WEIGHT)
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Nieuwe Steen Investments (NSTEc.AS, Eu15.72, NEUTRAL, TP Eu17.00, MARKET WEIGHT)
Segro Plc (SGRO.L, 319.60 p, NEUTRAL [V], TP 372.00 p, MARKET WEIGHT)
Unibail Rodamco (UNBP.PA, Eu150.00, OUTPERFORM, TP Eu171.00, MARKET WEIGHT)
VastNed Retail (VASN.AS, Eu49.45, OUTPERFORM, TP Eu56.00, MARKET WEIGHT)
Wereldhave (WEHA.AS, Eu70.96, OUTPERFORM, TP Eu79.00, MARKET WEIGHT)

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