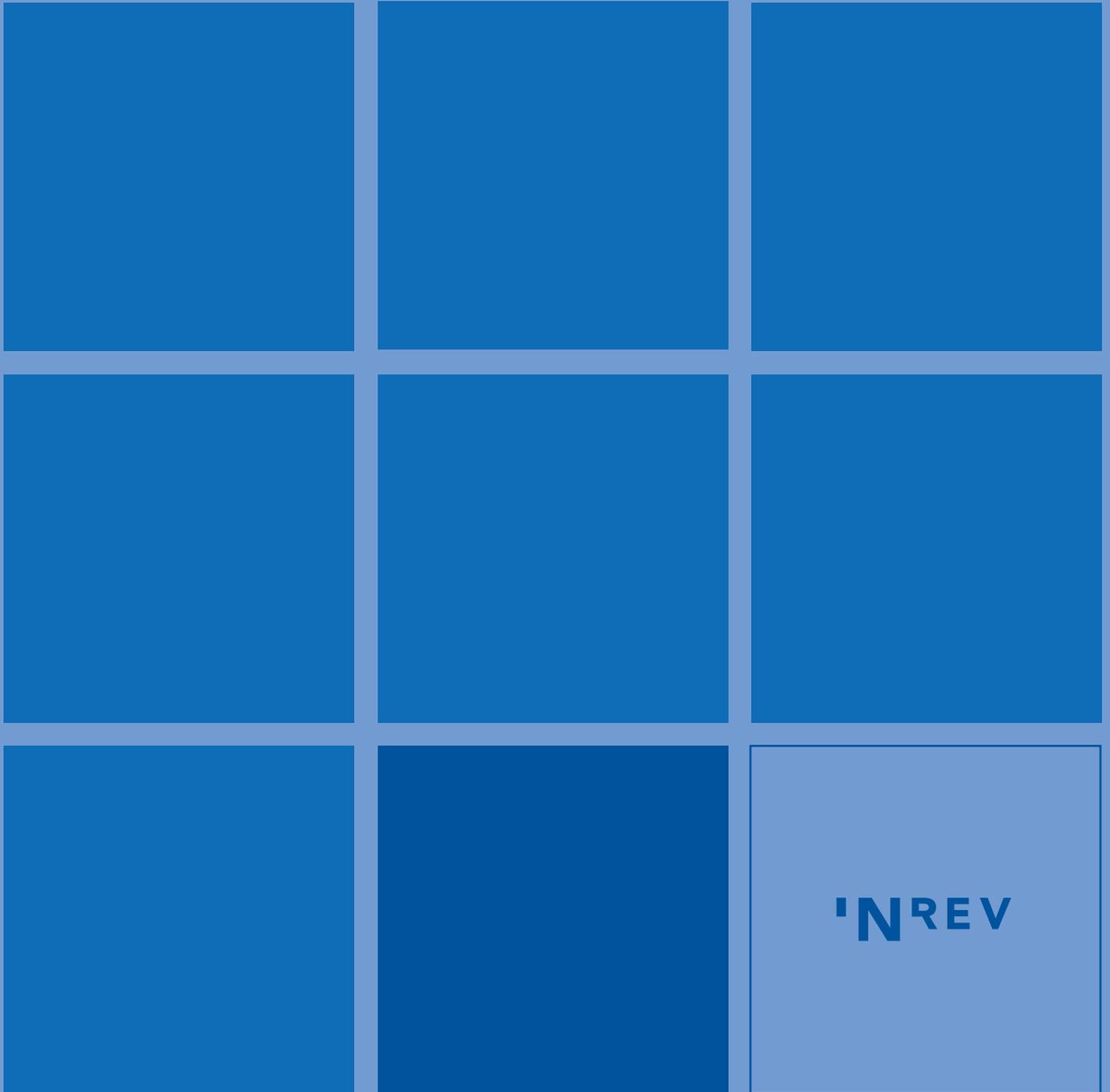


# REAL ESTATE AS A LONG-TERM INVESTMENT

The impact of regulatory change on long-term investing strategies and on the real economy



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## EXECUTIVE SUMMARY

Institutional investors such as pension funds and insurance companies invest in real estate as part of their long-term investment allocation. The long-term, secure, rental income stream associated with assets let on long leases to financially sound tenants, often incorporating inflation-hedging characteristics, has made real estate particularly appropriate for duration matching of assets and liabilities. While the investment emphasis is on the income stream, long-term investors further benefit from higher yields from the liquidity risk premium associated with real estate. This ability to enhance returns through long-term investing in real property greatly assists the ability of institutional investors to maintain their ability to meet their obligations in the future.

The aim of proposed regulations affecting institutional investors such as Solvency II and IORP II is to ensure they have the capacity to maintain their funded status in case an extremely unlikely event, or tail event, occurs, in turn securing market stability and protecting their beneficiaries. Yet, by failing to distinguish between investments tied to short-term liability profiles and those secured on long-term liabilities, these proposals artificially increase the volatility of institutional investors' balance-sheets. This has unintended consequences for long-term investors and the economy more broadly.

The requirement to mark long-term assets to market and ascribe a high risk weighting to real estate regardless of whether its income receipt is matched to a long-term liability, emphasises risk minimisation rather than risk optimisation. The pursuit of such low risk strategies also minimises returns. The scale of real estate risk weightings and their associated impact on the capital ratio outweighs any benefit of investing in such long-term assets with the aim of achieving a higher return. In addition, short-term mark to market accounting is used to calibrate the risk of long-term assets. Although this widely adopted practice is useful for many purposes and there are many good arguments for using a mark to market valuation approach, the same practice should not be applied for regulatory purposes. The use of this accounting methodology for the capital requirement calculation promotes a more pro-cyclical approach to institutional investing behaviour, increasing exposure to the risk of buying high and selling low. For investors with long-term liability profiles, proposed regulations increase risks to their future funding status.

The sharp reduction in counter-cyclical institutional investing increases the risk of wider economic instability. At the same time, a shift in emphasis from long to short-term real estate investing reduces the contribution of real estate to the wider economy. Previously, long-term counter-cyclical investing provided a floor in economic downturns. By focusing on the long-run value of assets, such investors are able to benefit from investing in assets that are under-priced relative to their long-term trend value. The expectation of a reversion to the long-run mean value enables such investors to be less concerned about any further modest downward volatility in pricing over the short term.

As well as the stabilising effect on the economy, such strategies provide important direct and indirect economic benefits. First is the direct importance of such investment to gross fixed capital investment in the economy. Second, the indirect benefits of high value long-term real estate investing as an economic growth multiplier through property management, construction activity and other services to business. Third, the positive environmental and social externalities that are derived from the implementation of long-term investing strategies, but are not produced from short-term investing in real estate. Fourth, counter-cyclical activity ensures the propagation of the real estate life-cycle, ensuring business has innovative product that, as a factor of production, enhances business profitability.

Without such activity, commercial real estate's role within the economy would be limited to being a mere factor of production for business. As such, real estate's role in the economy would shift from investment asset to a more passive consumption product. Worse still, it would tie up business capital and reduce business agility, flexibility, investment and innovation.

To avoid such negative externalities, proposed regulation impacting on institutional investors investing in real estate and infrastructure needs to differentiate long and short-term liability profiles and liquidity requirements. This would require liquidity management to be incorporated more explicitly into any overall investment strategy and asset allocation framework. Any performance measurement system needs to better balance short-term accountability against a long-term investing horizon.

*This study has been conducted by Brenna O'Roarty from RHL Strategic Solutions.*

# 1 INTRODUCTION

Historically, institutional investors such as pension funds and insurance companies have invested in real estate as part of their long-term investment allocation. The long-term, secure, rental income stream associated with assets let on long leases to financially sound tenants, often incorporating inflation-hedging characteristics, has made the asset class particularly appropriate for duration matching of assets and liabilities. While the investment emphasis is on the purchase of an income stream, much like a bond yield, long-term investors in real estate further benefit from higher yields as a result of the liquidity risk premium associated with the sector. This ability to enhance returns through long-term investing greatly assists the ability of institutional investors to maintain their funding status in the future. However, proposed regulations intending to promote stability within the insurance and pension fund investment market point towards a reduction in the capacity of such institutional investors to employ long-term investment strategies. This will have unintended consequences for their funded status and be detrimental to the real economy.

This paper considers the expected impact of regulatory change on long-term investing in real estate and its implications for the wider economy. First, it reviews the contribution of institutional investors to long-term investing. Importantly, it considers the factors that differentiate long-term investing, its significance to the maintenance of institutional funded status and its importance to the wider economy.

Second, this paper assesses the contribution of the real estate sector to the European economy. It emphasises the significant multiplier effect of investment in real estate and its wider beneficial externalities.

Third, the impact of proposed regulations on institutional capital allocations to long-term investing is explored. In particular, the paper highlights the consequences of linking capital solvency ratios to artificial balance-sheet volatility, which applied to long-term assets impacts investors' ability to maintain their funded status over the long term. Subsequently, its impact on institutional real estate investing strategies post-crisis is considered.

Finally, the paper considers the implications of new regulations affecting real estate investing on the real economy. The paper also evaluates the impact of lower and polarised investment on economic value creation, both in terms of size and distribution.

## 2 INSTITUTIONAL INVESTORS ARE CRUCIAL TO LONG-TERM INVESTING

Globally, approximately 42% of the €65 trillion of investments held by investors is controlled by long-term institutional investors with the capacity to invest long term. These include pension funds, insurance companies, foundations/endowments, sovereign wealth funds and private estates<sup>1</sup>. Together, pension funds and insurance companies are estimated to hold 34% of all investments. Of this, approximately 6.5% (weighted allocation) is estimated to be allocated to illiquid investments including real estate, infrastructure and private equity (€1.43 trillion). The total allocation to such long-term assets by all long-term investors is estimated at just under €2.43 trillion<sup>2</sup>. Pension funds and insurance companies are estimated to be responsible for 60% of such investments. The other investor categories identified as being capable of executing long-term investing strategies (including sovereign wealth funds, endowments and private estates), together control a smaller proportion of total investments (8.6%). The greater tolerance for illiquidity of endowments/foundations and private estates results in much higher allocations to long-term assets (20 – 35%), while sovereign wealth fund allocations are similar to insurance companies and pension funds. However, their approach to long-term investing differs.

### 2.1 What differentiates long-term investing?

The World Economic Forum usefully provides a definition of long-term investing as the ability to invest for an indeterminate holding period<sup>3</sup>. In making long-term investments, investors are focused on the long-term income growth and/or capital appreciation of an asset at the outset and throughout the investment period. Short-term price movements are of less importance to an investor focused on long-term value. While long-term investments are frequently held through a complete business cycle, or in excess of ten years, the holding period is less important than the capacity of an investor to undertake long-term investing. It is the investor's higher tolerance for illiquidity that is critical, enabling an asset to be held through periods of downward pricing volatility. Equally, a long-term asset may be sold earlier than anticipated if market pricing exceeds expectations.

Importantly, investment horizons are not merely about the illiquidity of assets. They reflect the investment intentions and risk appetite of investors. For example, real estate can be both a medium-term and a long-term investment. What differentiates the investment strategies is where the focus on value lies. For example, a pension fund making a long-term investment in a prime office asset is primarily concerned with purchasing the certain income flow of a long-leased asset. The presence of a residual value is to a great extent incidental. Indeed, 72.9% of investors indicated that the expected holding period for investments in core real estate is long-term<sup>4</sup>. This contrasts starkly with a shorter-term investor, more focused on short-term pricing expectations given the economic cycle and an asset's potential attractiveness to other buyers.

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<sup>1</sup> WEF (2011) The Future of Long-Term Investing, A World Economic Forum report in conjunction with Oliver Wyman.

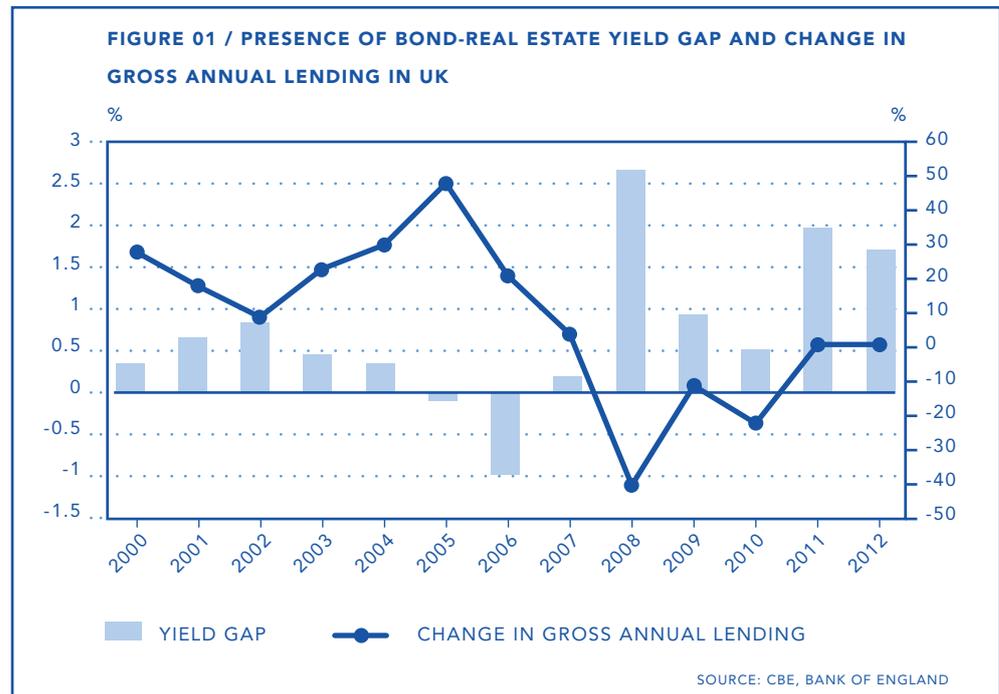
<sup>2</sup> INREV (2011) Legacy of the Downturn; WEF (2011) The Future of Long-Term Investing, A World Economic Forum report in conjunction with Oliver Wyman.

<sup>3</sup> WEF (2011) The Future of Long-Term Investing, A World Economic Forum report in conjunction with Oliver Wyman.

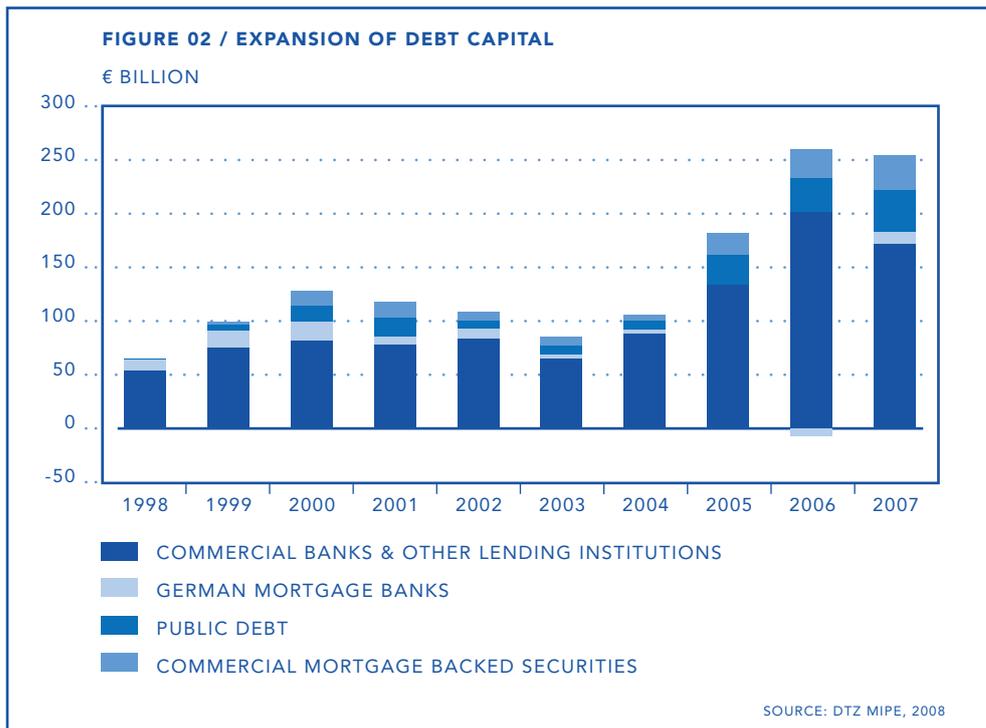
<sup>4</sup> INREV (2013) Investment Intentions Survey.

In essence, long-term investors are purchasing fixed income assets, often providing inflation hedging characteristics. Crucially, such investments are not intended to be available to meet short-term liquidity requirements. Rather, long-term investments are used to match future liabilities with secured income. Investors are therefore able to exploit the existence of a structural liquidity premium over the risk free rate, which compensates for such assets' perceived illiquidity. Despite having a low risk appetite, their capability of investing long-term enables such illiquidity and downside short-term volatility risk to be counteracted.

Being finite in scale, real estate and infrastructure markets are prone to over-heating from periods of sharp influxes of capital. Such capital tends to be driven by investors with a shorter-term horizon attempting to exploit what they have identified as a short-term arbitrage opportunity; that is, they are focused on short-term growth/mis-pricing rather than long-term income. Historically, these waves of excess capital have focused on the presence of a positive yield gap between the cost of borrowing and income return, facilitated by a sharp growth in the availability of debt capital (Figure 01). It is the over exuberance of such short-term investors that drives real estate bubbles rather than the longer-term institutional investor primarily focused on income and fundamental value. Since the downturn, bank de-leveraging and de-risking has led to scarcity and higher marginal cost of debt. Hence, this results in a temporal dislocation of the relationship between positive yield spreads and net lending. The ability of shorter-term, often private investors to invest in the real estate market is impeded. This is despite the attractive arbitrage opportunity present in the historically wide spreads between bond rates and prime real estate cap rates.



The difference between long-term and short-term investment was also fundamental during the bubble in real estate and infrastructure. Low/no leverage long-term institutional investors had increasing reserves of capital allocated to the sector and real estate pricing was moving sharply above long-term value. However, many insurance companies and pension funds pursuing counter-cyclical strategies became net sellers during the previous boom. Nonetheless, the increase in short-term investors, less experienced in the sector, and an expansion of debt capital propelled the bubble (Figure 02, page 07).



## 2.2 The importance of counter-cyclical strategies for the real economy

The rationale for undertaking long-term investing is that it can provide superior returns through exploiting liquidity and/or market risk premia. Based on the premise that most investments will move back to a mean reversion value over the long term, acquiring assets at or below their long-term real value trend is sensible. As well as providing further protection against downside volatility for the investment, such long-term counter-cyclical strategies provide a floor for real estate markets during downturns as well as for the real economy and economic value growth. Counter-cyclical investing provides a number of externalities that support economic stability and foster further sustainable economic growth. These include, but are not limited to: market stabilisation, and business development through product innovation and economic regeneration.

- (I) **MARKET STABILISATION:** The counter-cyclical nature of long-term investing greatly assists the stabilisation of financial markets during downturns. The re-emergence of such investors into the market as prices decline below their long-term trend provides a much needed liquidity injection. In turn, this enables markets to bottom out. Without this floor, markets are at risk of entering protracted crises. Low liquidity causes a downward spiral in value and in the quality of stock as asset management recedes. This results in further capital – and economic value – decline.
- (II) **SUPPORTING BUSINESS CHANGE THROUGH PRODUCT INNOVATION:** The capacity to undertake long-term investing enables structural, macro and sectoral trends to be exploited. Major structural macro-economic trends are well established and include ageing society, depleting natural energy resources and climate change, urbanisation, wealth polarisation, technological revolution and the shift from a service to knowledge based economy. Previously, long-term investing in real estate and infrastructure has been a critical facilitator of such change, creating solutions that act as a factor of production. In turn, this enables policy makers to manage the change

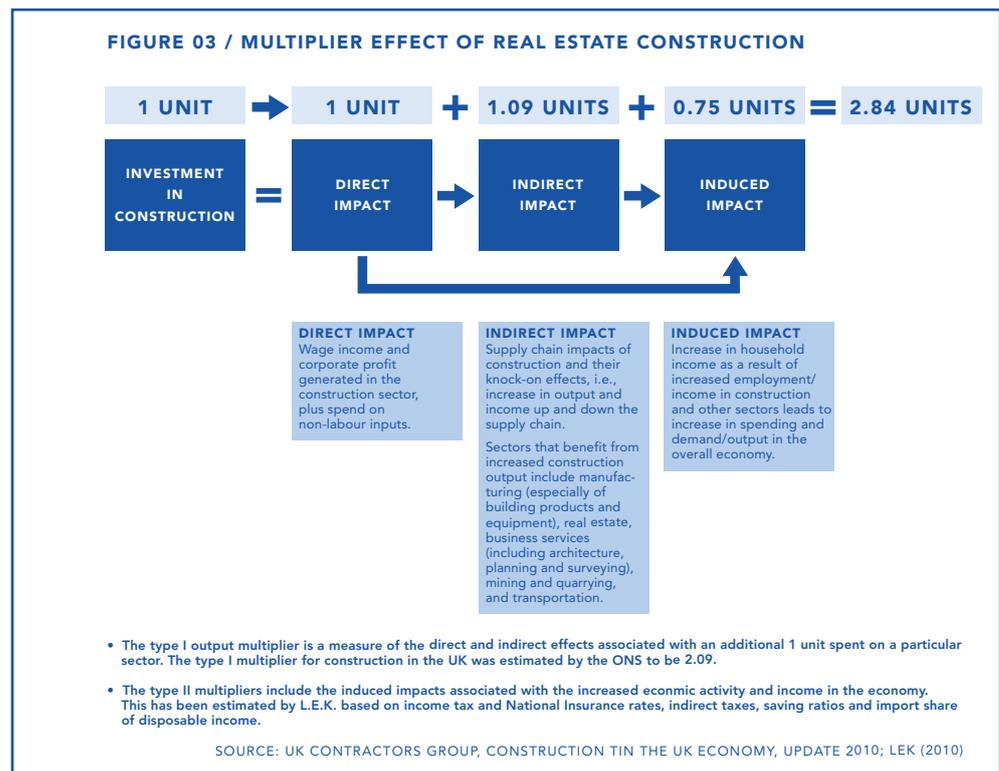
process, creating economic value while minimising economic dislocation. For example, technological innovation enabled the de-regulation of financial markets in the late 1980s. Recognising these trends, long-term investors in real estate engaged in product innovation. They transformed the functionality of business space and at the same time regenerated obsolete locations. Urban regeneration requires a long-term investment horizon which recognises that the creation of economic value through employment growth, improved accessibility, educational attainment and improved living standards is the key to unlocking real estate value. Notable examples include Broadgate in the City of London and, in tandem with policy makers, the London Docklands and La Defense in Paris. Such innovation provides occupiers with a major factor of production. This generates efficiencies in business operations through increased functionality of the actual space and the creation of a wider marketplace across the micro-location. Other examples include, but are far from limited to, big box retailing, hotels and resorts, student housing, business parks, science parks and leisure.

The involvement of institutional investors in the real estate investment process is critical. Large institutional investors are regarded as “Universal Owners” given the large, highly-diversified and long-term investment portfolios they possess. Their portfolios mirror the structure of capital markets. As such they are affected by wider economic and societal positive and negative externalities. Importantly, their role as social partners and ability to focus on longer-term economic and societal well-being as being fundamental to beneficiaries interests assists in generating wider economic and societal positive externalities. In short, the role of institutional investors is not merely as purchaser of the end product. Rather, there is an alignment of the objectives of long-term universal investors and public authorities, not shared by shorter-term investors. The rejuvenation of Europe’s decaying waterfront cities, rundown city centres and investment in job creation in deprived suburbs would not have occurred without the presence of long-term investors able to engage in private and public sector regeneration partnerships.

### 3 THE IMPORTANCE OF REAL ESTATE TO THE REAL ECONOMY

The commercial real estate sector has a capital value of €5 trillion, making it comparable to the scale of Europe's equity (€7.1 trillion) and bond markets (€7.5 trillion)<sup>5</sup>. It directly contributes 2.5% of European GDP, employing over 4 million people and involving the participation of nearly a quarter of all SMEs. As such, its economic importance outweighs that of the European car and telecommunication industries. At 72%, construction accounts for the largest proportion of commercial real estate (CRE) employment. While investment, fund and portfolio management represent around 1% of CRE employment, they have a disproportionately high contribution to value added economic activity. Their activities underlie demand for third party agents (5% of CRE employment) and professional property management companies (23% of CRE employment). Moreover, they act as a stakeholder in the development process, stimulating construction demand.

Previous research has attempted to quantify the multiplier effect of construction activity on the wider UK economy. The results indicate that the impact is substantial. Every unit of investment in the sector delivers a multiple of 2.84 in terms of economic output (Figure 03)<sup>6</sup>.



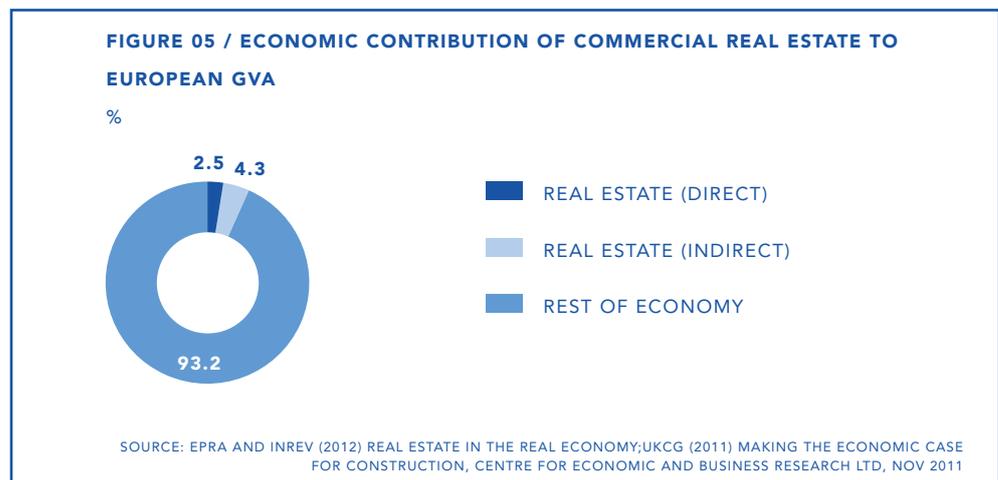
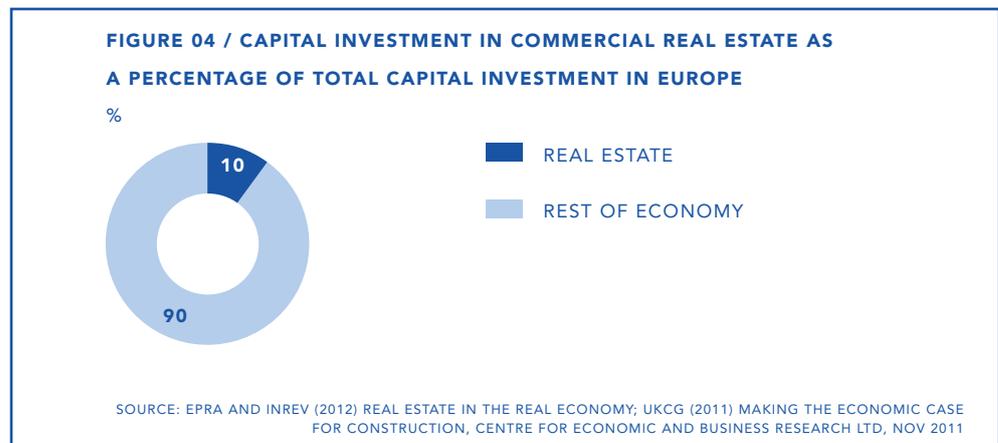
Investment activity in the (re-)development, refurbishment and re-positioning of the built environment increases employment in construction, related professional and manufacturing sectors. This has a direct impact on employment, wages and corporate profits within the construction industry. In addition, it stimulates demand through the manufacturing and materials supply chain and in related business services. Together, the direct and indirect

<sup>5</sup> EPRA and INREV (2012) Real Estate in the Real Economy.

<sup>6</sup> UKCG (2011) Making the economic case for construction, Centre for Economic and Business Research Ltd, Nov 2011.

benefits create a value add of 2.09 for every unit invested<sup>7</sup>. Importantly, low skilled workers with limited transferable skills, often unable to find alternative employment comprise a high proportion of the construction workforce. Research within the UK market indicates that lower skilled workers represent 62% of employment in the construction sector. This proportion is considerably higher in regions with above average unemployment rates. The induced impact of the higher employment of lower-skilled workers on private consumption accounts for 0.75 of the 2.84 value add for every unit invested in construction. Moreover, there is considerable appreciation of standard of living and quality of life indicators.

On average, development and re-development of new and existing commercial real estate amount to €250 billion of capital investment per annum, representing 10% of total capital investment in Europe (Figure 04). The multiplier effect suggests this delivers an economic value of some €710 billion, equating to 6.8% of European GDP (Figure 05). In addition, there are further significant indirect and induced benefits that remain un-quantified.



First, real estate investment plays a vital role in facilitating European business and industry. The provision of appropriate premises is equal in importance to plant and machinery as a vital factor of production. Indeed, they are of a similar value. While owner occupation

<sup>7</sup> L.E.K. Consulting on behalf of UK Construction Group (2010), Construction in the UK economy, October.

remains the preferred option for a significant minority of business occupiers, over 50% of European commercial real estate is held by third party investors. Their provision of leased space and associated services enables greater flexibility and agility for European business. Moreover, the ability to lease rather than own real estate enables many businesses to release capital for investment in expansion, productivity gains and R&D. The use of capital for investment rather than consumption results in a multiplier effect for economic value creation for both real estate investors and business occupiers.

Second, the regeneration of the built environment provides the skeletal framework for developing sustainable economic growth. It delivers the factors of production required to entice businesses to re-locate (accessibility, appropriate business space, services) and rejuvenates civic centres through the provision of retail, leisure, education and health facilities. Private and publicly listed property companies spear-heading urban regeneration partnerships do so with capital (debt and/or equity) support from institutional investors. Moreover, they commit to development programmes in the knowledge that there is institutional investment demand for their product; a real asset providing an institutionally attractive income stream.

From the institutional investor perspective, the long-term cash flows generated from such real estate investment provide a significant source of enhanced returns and portfolio diversification. Importantly, they enable long-term liability profiles to be matched to long-term, often inflation linked, sources of income. This benefits European pensioners and savers. Given Europe's ageing population profile, it also benefits wider society. However, new regulations aimed at promoting economic stability are resulting in a reduction in allocations to less liquid assets such as real estate and to long-term investing strategies more generally.

### 3.1 Responsible investing, commercial real estate and sustainability

Being universal investors, insurance companies and pension funds understand the importance of promoting sustainable economic growth. Over 700 of such investors have signed the UN Principles for Responsible Investment and are integrating environmental, social and governance criteria into investment decision-making. Such investors hold short- and long-term investments. However, it is the presence of long-term investment horizons that enables them to anticipate, innovate and capitalise on the impact of long-term structural trends. The capacity of multi-generational investors to anticipate and respond to the implications of externalities on their portfolios before they are internalised is a source of real value to institutions. It enables long-term returns to exceed the sum of compounded short-term returns<sup>8</sup>. This pro-action creates further positive externalities for economy and society that are unlikely to be generated by shorter-term investment horizons.

Contrary to long-term investments, shorter-term investing horizons cannot take account of anticipated structural change given uncertainty as to timing. As such, short-term investing tends to be more reactive to change. That is, the response to change occurs after the impacts of negative externalities have already been internalised within portfolios. This is particularly true of real estate given its fixed attributes of location, building materials and operational systems. Considering that buildings account for 40% of the EU's energy consumption and a third of its emissions, a reduction in long-term investing in the sector is of concern<sup>9</sup>.

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<sup>8</sup> Towers Watson and Oxford University (2012) Sustainability in Investment – We need a bigger boat, August.

<sup>9</sup> EPRA and INREV (2012) Real Estate in the Real Economy.

Non-residential real estate accounts 12% of the EU's energy consumption and greenhouse gas emissions. As such, increasing energy efficiency within buildings represents a major potential source of achieving sustainability targets. However, the required investment to realise energy savings is estimated at €60 billion a year over the next decade. The financial payback period requires a longer-term investment horizon. Long-term investing strategies in real estate and infrastructure are able to take account of the longer-term investment benefits of increasing sustainable sources, reducing emissions and increasing efficiency. Shorter-term investing would result in a greater emphasis on reducing short-term energy costs rather than implementing sustainable solutions. As well as a failure to reduce carbon emission, over time this will result in increasing rates of obsolescence.

## 4 THE IMPACT OF NEW REGULATION ON CAPITAL ALLOCATIONS

There are two inter-linked requirements within proposed legislation that will likely lead to a sharp decline in long-term investing in real estate and infrastructure by pension funds and insurance companies. First is the mark to market accounting requirement for assets and liabilities embodied in proposed Solvency II and IORP II regulation. Indeed mark to market accounting is already a standard accounting requirement of IFRS, GAAP and industry bodies such as the RICS. A recent INREV survey indicates that 77% of European non-listed funds report according to IFRS (46%), US GAAP (14%) or UK GAAP (16%) accountancy standards, which require market to market accounting<sup>10</sup>. However, while well suited for other purposes, the use of mark to market accounting as the denominator for calculating solvency capital requirements results in artificially inflating balance-sheet volatility for long-term holdings. By failing to differentiate between short and long-term investing horizons, new regulations force institutions to be concerned with short-term volatility even for long-term liabilities. Effectively, it removes any advantage of institutional investors' capacity for long-term investing. The validity of assessing current values of illiquid assets through mark to market accounting is also debatable. As the OECD noted, 'the mark to market philosophy may be particularly damaging for long-term investors, attributing instant market values to assets whose valuations may take years to accurately assess.'<sup>11</sup>

Second, the proposed regulations require all assets to be risk weighted according to their volatility and liquidity to determine the capital reserve requirement. Again, this is applied universally. How investments are designated in regard to their availability to meet short-term capital reserve liquidity requirements and any duration matching of the liability profile is entirely disregarded. This exacerbates the impact of the mark to market accounting in determining the required capital ratio as higher capital charges apply to assets displaying higher volatility. The UK, as an example, has already witnessed a shift away from higher risk assets such as equities following the earlier introduction of minimum funding ratios in 1997 followed by market to market accounting and greater matching of assets and liability from 2000. Again, the risk weightings fail to discriminate investments according to their matched liability profiles and, in turn, their designation as to fulfilling any liquidity requirement. As a result, the ability of these universal investors to make long-term investments is constrained regardless of their liability profile. This has a direct impact on the ability of such investors to exploit their advantageous capability of making long-term investments. Unintentionally, this is expected to result in institutions with long-term liability profiles failing to meet future liabilities. In doing so, new regulations promote a sub-optimal risk return allocation. Moreover, the sharp reduction in the availability of long-term investment and development capital allocated to real estate has detrimental consequences for the real economy, both directly and indirectly.

Regardless of duration matching, the proposed regulations ensure that short-term pricing volatility counts for even long-term, effectively fixed income assets, matched to long-term liabilities. Of course, the value of all assets should be monitored throughout their holding period to distinguish between cyclical and structural shifts in value. The difficulty is that by

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<sup>10</sup> INREV (2013), Fund Valuation and Reporting, Educational Training.

<sup>11</sup> OECD (2011), Financial stability, fiscal consolidation and long-term investment after the crisis. *Journal of Financial Market Trends*. Vol. 2011 (1), 14. (referencing: De Larosi re, J. (2010), "Long-term Investment: What Appropriate Regulatory Framework?", *The Longterm Investment in the Age of Globalisation*, Rome, 17th June).

linking the mark to market value of long-term real estate assets to funded status (exacerbated by an inflated risk weighting), investors are encouraged to be overly concerned about short-term price movements. The proposed regulations are driving pension funds and insurance companies away from long-term investing.

The promotion of short-term investing, together with a growing significance of short-term price movements for regulatory classification, encourages a pro-cyclical approach to investment strategies. Therefore despite being able to acquire assets well below their long-term trend value with the expectation that over the long-term asset prices revert to their mean value, investors are now much more concerned as to timing and encouraged to invest in line with the momentum of market trends. Tolerance for any further value decline over the short term has been diminished by proposed regulation. In keeping with pro-cyclical incentives, strategies are executed only after the turning point in the market, resulting in a greater exposure to buying high and selling low. To this end, the requirement of mark to market accounting and its contribution to calculating the solvency capital ratio is also removing the crucial contribution of institutional counter-cyclical investing to market stabilisation.

Regulatory uncertainty has already led to a deferral of real estate investment by institutional investors given its long-term investment horizon, illiquidity and relatively higher costs of execution. This is evidenced by the relatively low activity of pension funds in the real estate market post-crisis, despite having high reserves of allocated capital to the sector and the opportunity to acquire assets below their long-term trend value. Worse still, the low risk weighting associated with sovereign and corporate bonds incentivises institutional investors to increase allocations to such fixed income products. This is despite the wide acceptance that the expansionary monetary policy required to manage the financial crisis has maintained long-term interest rates at artificially low levels in perceived safe haven markets. As a result, the regulatory implications for future funding ratios are two-pronged: lower allocations to long-term investing reduces the ability to generate higher returns by exploiting a liquidity premium and higher allocations to bonds reduces performance due to excess demand for an over-priced product.

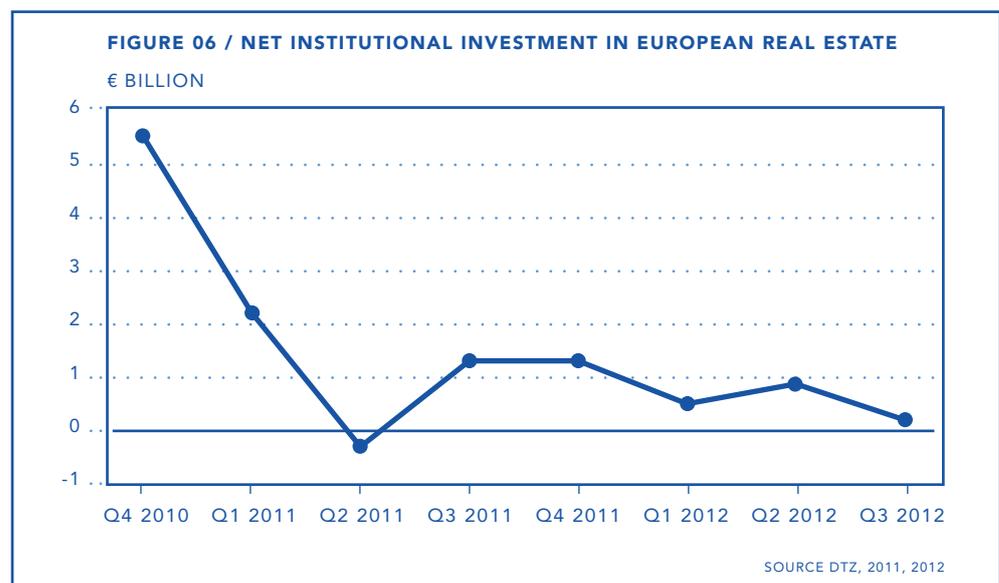
The proposed regulations are designed to ensure that pension funds and insurance companies are able to withstand a 1 in 200 year solvency event. The World Economic Forum estimate this equates to a one year fall in the value of public equities of up to 45% and a decline of 55% for private equity. Although the standard capital charge for real estate is 25%, which is widely considered to overstate real estate volatility in Europe, the lower liquidity of real estate would require institutions to hold an additional buffer. To maintain the current allocation to equities and long-term investments such as real estate and infrastructure would require pension fund capital reserves to increase by approximately 30%. Given the high risk weightings associated with more illiquid assets, disinvesting from longer-term investing strategies in real estate, infrastructure and private equity has a disproportionate impact on improving capital ratios relative to asset value. At the same time, such activity increases risk by reducing diversification and, at the same time, lowers expected returns. Resulting in a sub-optimal risk return allocation, the proposed regulations are inadvertently injurious rather than protective of beneficiaries.

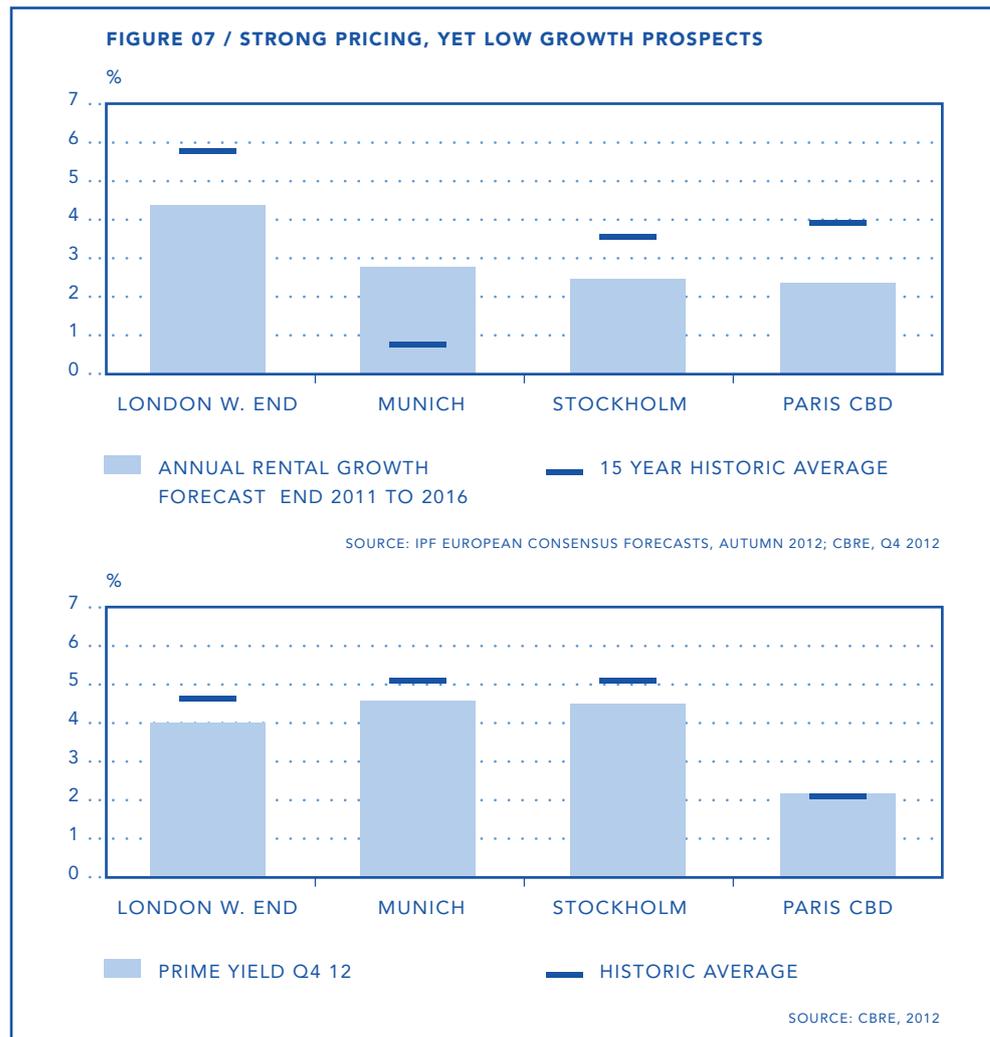
## 5 REGULATORY IMPACT ON THE POST-CRISIS INVESTMENT STRATEGY

The shift in investor allocations away from long-term, counter-cyclical investment strategies is evident in the scale, timing and allocation of investment capital. While this initially reflected the strength of investor risk aversion in the aftermath of the crisis, the proposed regulations exaggerate and prolong these trends due to their over-emphasis on short-term risk rather than optimising risk and return over the investment horizon. This is manifested in investment allocations and strategy in two inter-related trends. First, investment volumes are low relative to historical trends and the timing of investment is consistent with a pro-cyclical strategy. This is despite the context of the strong counter-cyclical opportunity that persists. Second, investment strategies are narrow in focus.

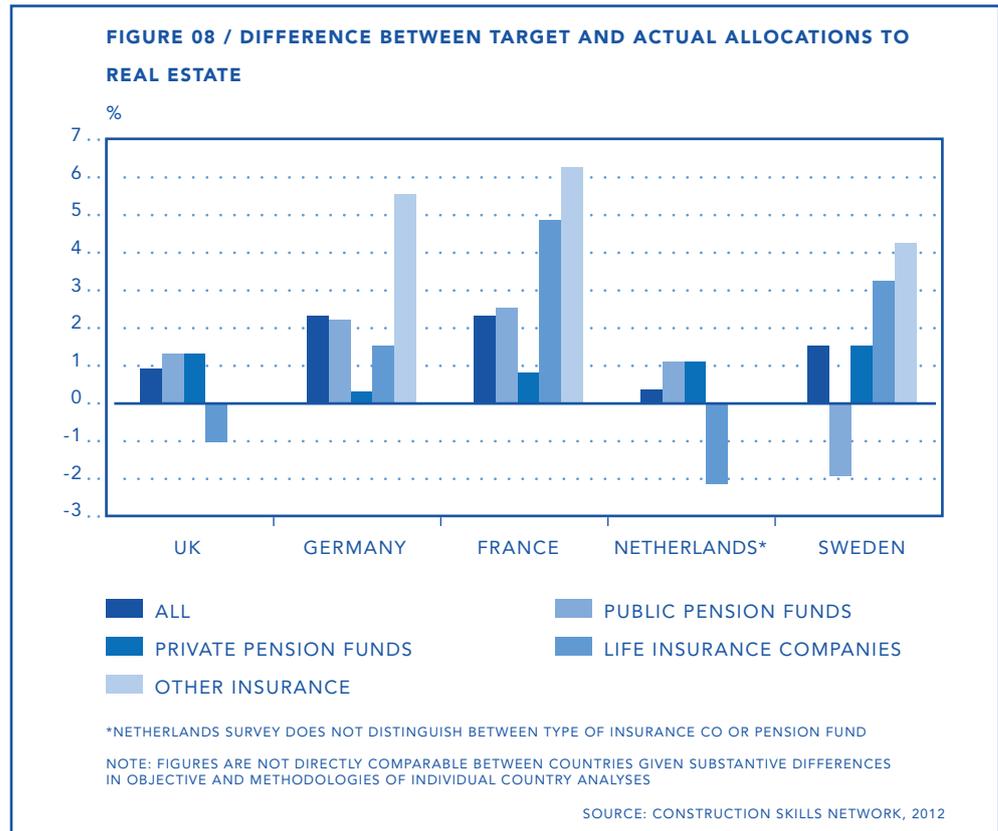
### 5.1 Low volume, pro-cyclical investing

Net investments in real estate have fallen from their post-crisis peak at end 2010 to a positive yet broadly neutral position by Q3 2012 (Figure 06). This timing of investment represents a more pro-cyclical investment strategy than in previous cycles, with the peak of investment occurring after or coinciding with the turning point. Given muted rental growth prospects, analysis suggests that the pricing of this narrow, prime element of the market has moved well above its long-term trend (Figure 07, page 16). This would result in disinvestment if traditional real estate investment counter-cyclical strategies were pursued. However, the over-emphasis of proposed regulation on minimising short-term risk, rather than optimising risk and return over the investment horizon is resulting in a shift in the timing of investment strategies. With Solvency II requirements having been announced by end 2010, it is perhaps unsurprising that the positive net investment has been largely driven by insurance companies, keen to secure fixed income style investments. The flight to safety has driven bond rates down to unsustainably low rates against which prime real estate yields are attractive, despite their weak income growth prospects. Both bond rates and prime yields are expected to rise mid-term resulting in capital value erosion. However, given the higher real estate yield and expectations of a more limited pricing correction, prime, income secure real estate represents the lesser of two evils to such fixed income investors.





Similarly, pent up capital that has been allocated but remains un-invested has also been uncovered (Figures 08, page 17). INREV research on institutional capital allocations to real estate over 2010 and 2011 across six markets (UK, France, Germany, Netherlands, Sweden and Finland) indicated that institutional investors were under-invested in real estate relative to their capital allocations by some €95 billion. This includes undrawn allocations to non-listed funds and is subject to the denominator effect of price movements in other asset classes. DTZ estimate the amount of global institutional (pension funds and insurance companies) capital available for direct real estate investing in Europe is €43 billion, representing a doubling of estimated available capital since end 2010. However, this is not reflected in their investment activity. The institutional market share of real estate capital investment has halved post-crisis to circa 11%.



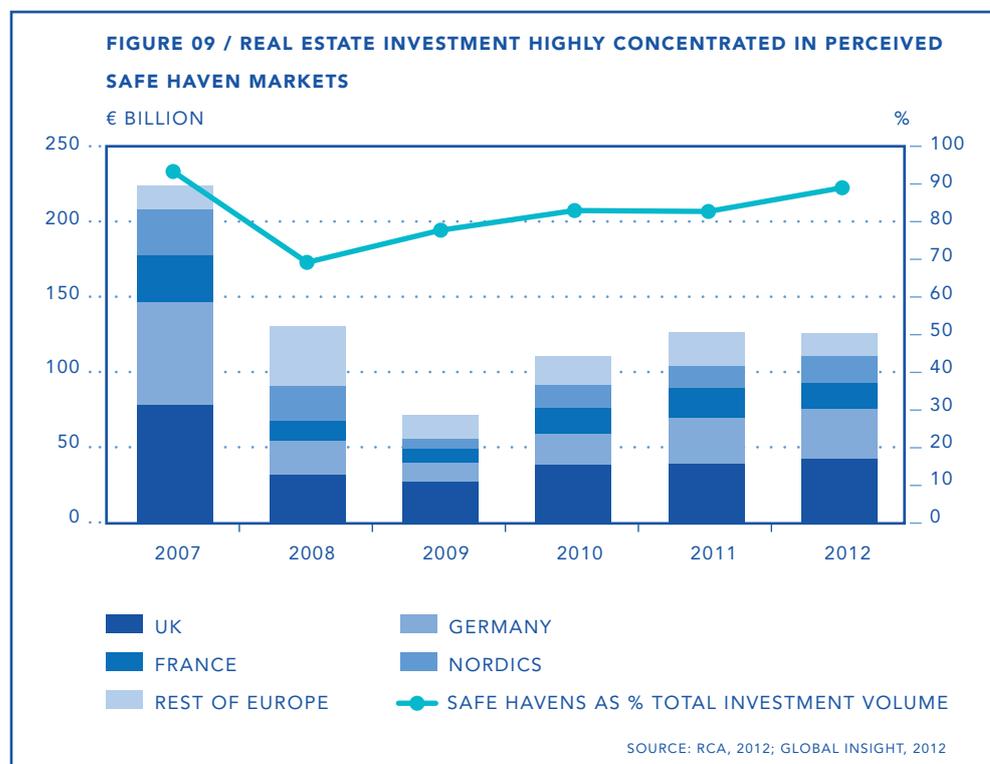
Large corporates with excellent credit ratings have been taking advantage of the increased appetite for low risk, fixed income products. By re-structuring real estate holdings into sale and leaseback opportunities, corporates have been able to release embedded capital at attractive yields. Fixed income style institutional investors are attracted by the opportunity to purchase a long-term income stream from a low credit risk corporate, at a relatively higher yield to that achievable for the same covenant in the corporate bond market. Their focus on fixed income and risk minimisation has resulted in some investors splitting the income and growth components of such assets, selling the residual to a third party. While such activity is increasing the invested real estate universe, it represents a dilution of allocated capital to real estate. Investment in even good quality non-prime assets remains low, resulting in further value deterioration and, in turn, a decline in their contribution to the invested universe absolutely as well as relatively. While large corporates are able to release embedded capital for investment, small and medium sized business occupiers are faced with deterioration in the under-invested non-prime real estate market. Increasingly, such occupiers fail to make the grade of covenant required for prime, income secure assets. As a result, owner occupation is anticipated to increase for SMEs, embedding much needed investment capital and reducing their flexibility and agility.

## 5.2 Narrow and narrowing real estate investment focus

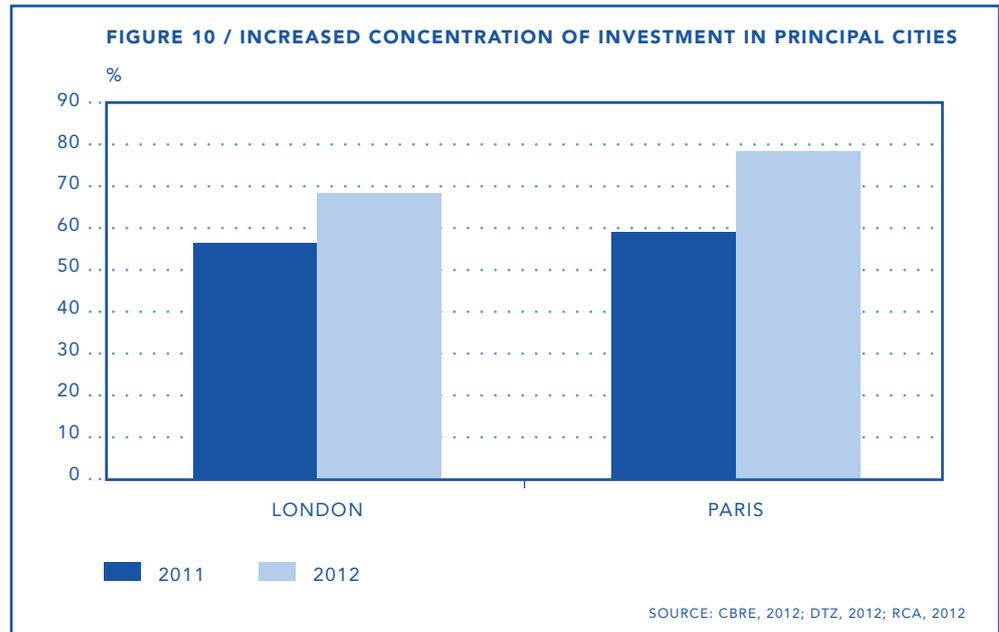
Initially, low levels of real estate investment reflected heightened market volatility and capital market seizure; more recently the over-emphasis of proposed regulation on minimising short-term risk is also resulting in a shift in the timing and scale of investment strategies. The fostering of a more short-term, pro-cyclical narrow approach is having a detrimental impact on the performance of institutional portfolios. In addition, there is already some evidence of a reversal in the beneficial externalities of long-term investing strategies on the direct and indirect contribution of real estate investing to the real economy.

Investor expectations following the publication of proposed regulations has exaggerated and sustained the extreme investor risk aversion present at the inception of the financial crisis in 2007/8. This is characterised by strong competition for prime, income secure assets in mature sectors of the principal markets of a narrow range of perceived safe haven countries. That is, investment strategies are constrained by geography, market size, location, leasing profile and asset quality.

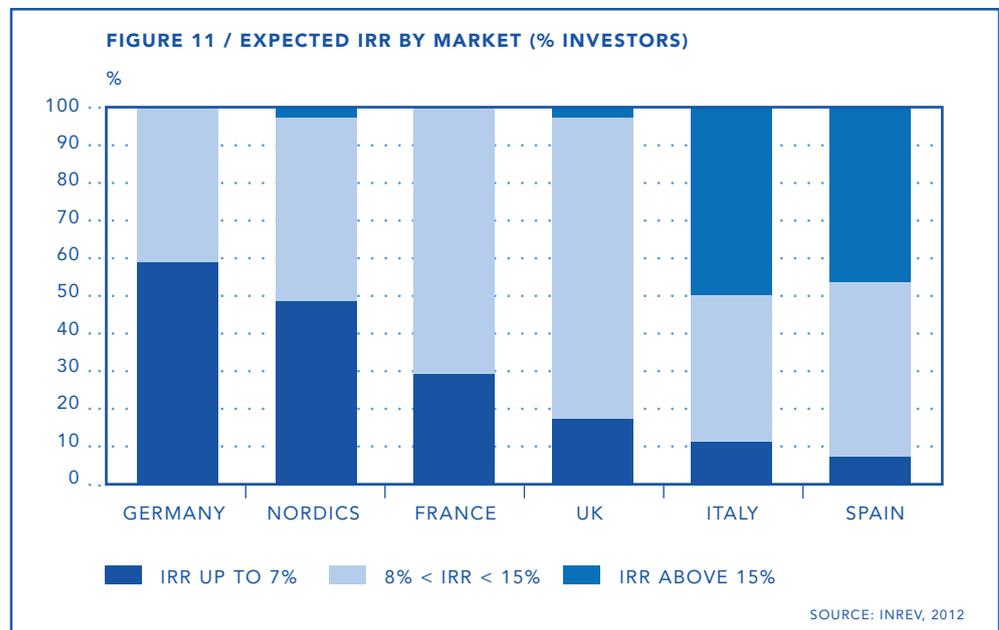
The UK, France, Germany and Nordic markets are perceived as safe haven real estate markets, given their scale and/or perceived greater economic stability. Collectively they accounted for 60% of investment activity from 2004 to 2007. Since the downturn, these markets have seen their collective share of investment volumes increase to a high of 87% at Q3 2012. This represents a sharp up-weighting relative to their share of European trade area GDP at 57% which, in contrast, has been relatively stable over the past decade (Figure 09). Moreover, even within this narrow range of markets there has been increasing concentration of investment in principal prime location and assets.



The UK accounted for 44% of all European investment volumes at Q3 2012. In the decade preceding the boom the UK's share of European investment activity averaged 28%. Similarly, within the UK, investment activity is concentrated in the principal London office markets. London's share of investment volumes in the UK increased from 46% at end Q1 2011 to 68% by mid-2012. Investment outside Central London is largely accounted for by prime shopping centre transactions and corporate sale and leaseback portfolios. Similarly, investment in Paris accounted for 59% of investment volumes in France over 2011 which increased to 78% by mid-2012 (Figure 10, page 19).

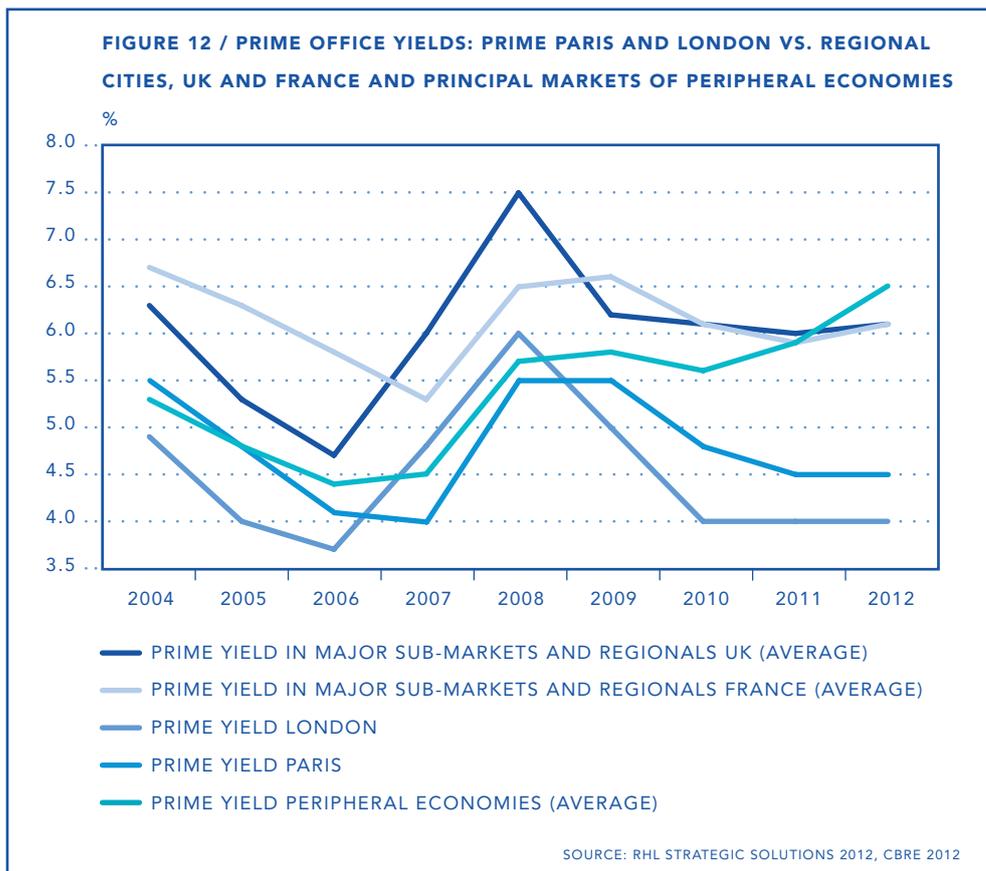


This narrow geographic focus on prime, income secure assets in principal cities has resulted in prime cap rates falling to levels approaching those achieved at the market peak. As for fixed income investments, institutional real estate investors are prepared to accept very low returns to achieve minimal risk exposure. Indeed, previous research undertaken by INREV indicates that investors expect the markets with the strongest capital allocation to deliver the lowest absolute returns (Figure 11).



Beyond this narrow definition of what constitutes prime or core investing, yields remain elevated. Of course, a positive spread should persist between prime and non-prime real estate yields to compensate for any additional risk present in the attributes of a non-prime asset. These may include lower liquidity as a result of market size or location, differences in market or sector maturity, building quality and/or leasing profile, including income risk.

However, while yields on prime assets in favoured markets are subject to strong pricing, many prime assets in non-core markets and non-prime assets in perceived safe haven markets remain well below their long-term trend value. The yield spread between prime and secondary assets has continued to escalate since the crisis, resulting in a dislocation of the long-term co-movement of prime and secondary markets. For example, the spread between prime office market yields in safe haven markets in comparison to the southern peripheral economies, or between principal cities such as London and Paris and prime yields in regional office markets in the UK and France have reached historic highs (Figure 12).



Similarly the yield spread between prime and non-prime assets continues to widen, even in markets that are perceived safe havens because of their stability and growth, not merely scale, for example, Sweden. Comparison of prime office yields in Stockholm CBD with good quality office assets in even the strongest sub-markets reveals a yield spread of 200 bpts<sup>12</sup>. Spreads are substantially higher for assets in strong markets with weak leasing profiles (300+ bpts) or for good quality assets in weaker sub-markets (250+ bpts). Yet recent research suggests that the prospects for the secondary office market are considerably stronger than for prime for a number of reasons<sup>13</sup>.

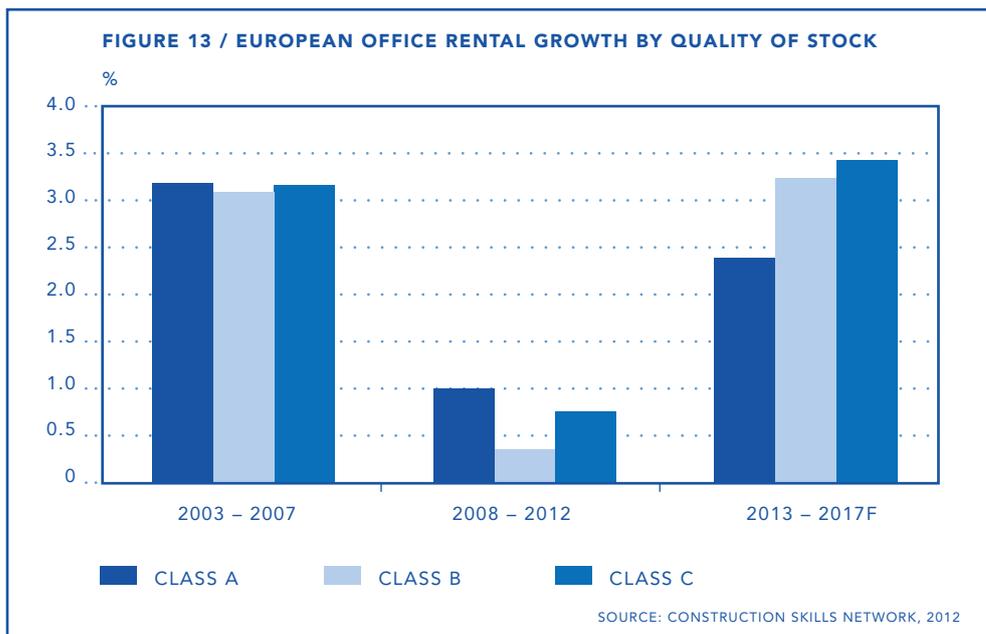
First, non-prime rental growth is expected to outperform prime. Historically, prime rental growth is considerably more volatile than average rental growth. Changing demand dynamics suggest that although prime rental levels have recovered since the downturn, the customary

<sup>12</sup> JLL (2012) Nordic Outlook, JLL, Autumn.

<sup>13</sup> Genesta Property Nordic (2013). 'The duality of mis-pricing', Nordic Insight, January.

spike in prime rents is unlikely to transpire in the current cycle. Amid wider European economic turmoil and fragile business confidence, occupiers remain focused on managing their cost base. The pace of prime rental growth has stabilised despite strong occupier demand and a scarcity of prime space. Instead, rental growth has spread to non-prime locations and assets. Indeed, the level of affordability offered in the strongest sub-markets resulted in substantially stronger rates of growth over 2012 than those achieved in the prime CBD. Second, the low availability of finance, especially in regard to speculative development, protects against any downside volatility. The growth phase of the cycle is extended as an absence of finance impedes the already lagged supply response. Third, the mis-pricing of non-prime assets neutralises any impact on value from an expected rise in bond rates mid-term. Indeed, given the strength of rental growth prospects, yield compression is anticipated. In contrast, muted prime rental growth is unlikely to compensate for a widely anticipated upwards correction to prime yields mid-term.

Similarly, recent research undertaken by DTZ utilising a proprietary transaction database suggests the spreads between prime and secondary yields are overstating income return risk. Their analysis suggests that low availability and low affordability of prime space, in the context of a cost-conscious and risk averse occupier base, is increasing secondary market lease renewal rates, while tenant default rates remain low. At the same time, having deteriorated further and for longer, non-prime rental growth prospects are stronger than for prime real estate (Figure 13).



Despite the stronger risk adjusted return prospects for prime assets in regional markets or strong non-prime locations in principal cities, institutional counter-cyclical activity remains negligible. Proposed regulations that ascribe a high risk weighting and over-emphasise the importance of short-term price movements are resulting in low investor demand. Consequently, a downward spiral is occurring in these markets that not merely affects value, but quality of stock as capital expenditure declines.

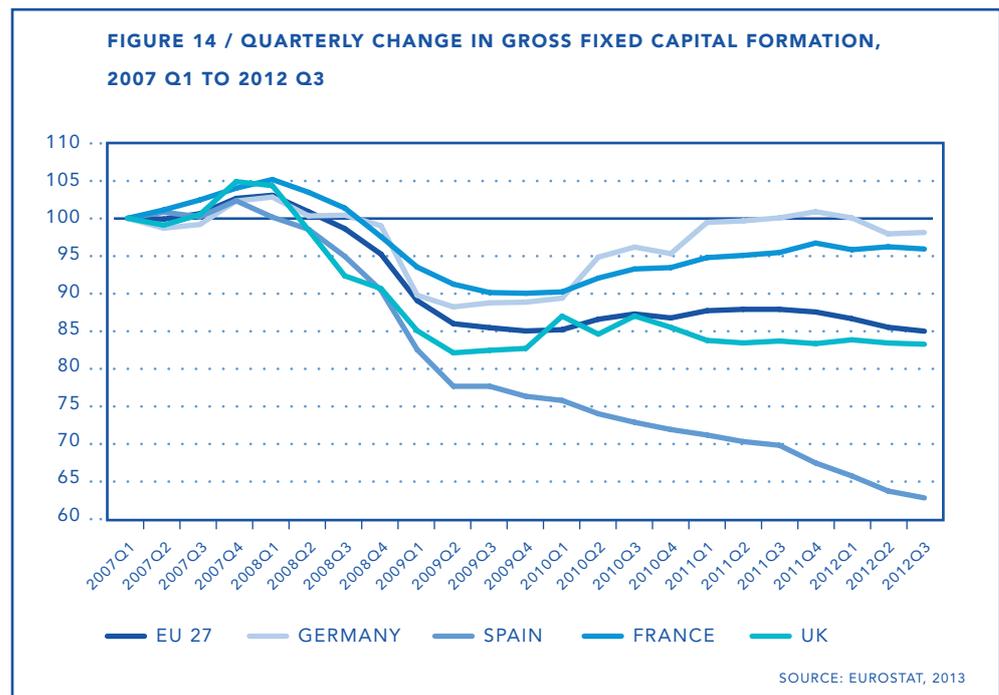
Solvency II and IORP II directives, if implemented as currently proposed, ensure that these markets will continue to suffer from an absence of demand from institutional capital, despite stronger risk adjusted return prospects. Similarly, the risk weighting ascribed to such assets within the Basel III regulatory framework results in their removal from banks' loan portfolios, having a disproportionately beneficial impact on capital ratios. This results in a two-pronged attack on the sector. Alternative private or more opportunistic investors are unable to obtain financing for acquisitions, while banks withdraw from existing loans through sale of discounted loan portfolios or refusal to renew upon expiry of term. This ensures a low capital allocation to the non-prime market, resulting in further divergence of prime and secondary markets.

## 6 NEW REGULATIONS AND REAL ESTATE: IMPLICATIONS FOR THE REAL ECONOMY

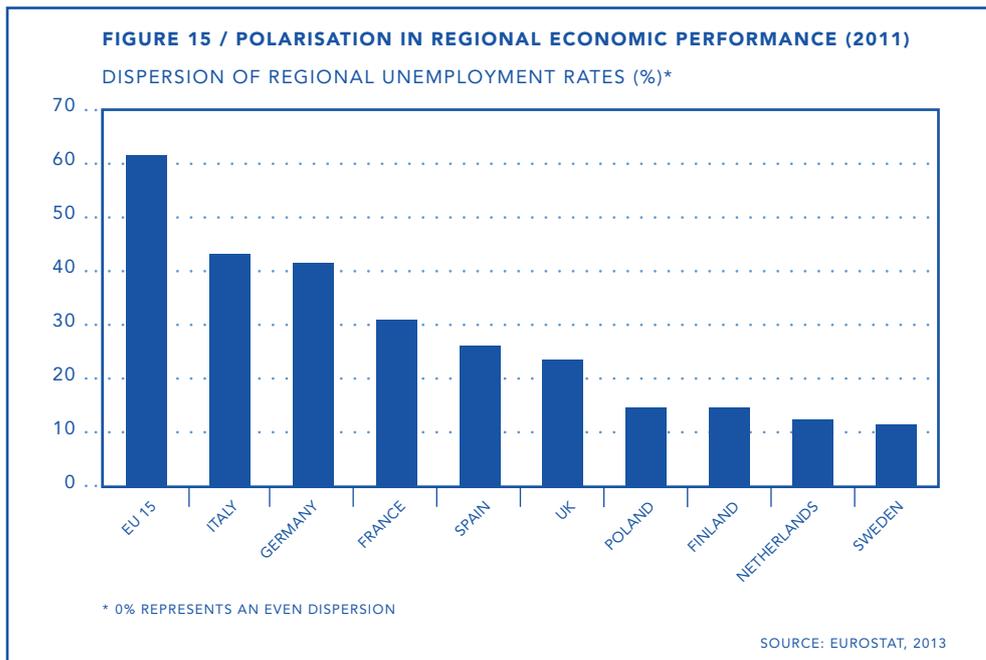
The decline in institutional long-term real estate investing has detrimental consequences for the real economy and it is accelerated by the shift to shorter-term investing strategies. The resultant narrow focus of institutional investment strategies on prime, income secure, high quality assets in a narrow range of principal markets reduces both the scale of economic growth and its sustainability.

### 6.1 Focus on core, prime locations

The geographic polarisation of European real estate investment since the downturn, as discussed above, would historically have represented a strong counter-cyclical opportunity. Moreover, it would have assisted in stabilising markets. Institutional investment remains low for even relatively high yielding, prime income secure assets in these markets' principal cities. Within Europe, commercial real estate investment is estimated to contribute 35% of gross fixed capital formation in non-residential buildings and other structures. The absence of such real estate investment exacerbates the rapid decline in total investment in stressed economies, acting as a drag rather than a stimulus to economic growth (Figure 14).



Low capital investment also has a detrimental impact on the quality of stock, culminating in a virtuous circle of decline. This polarisation in investment is also evident in the regional dispersion of investment in even the largest core economies. Increased concentration of investment, as discussed earlier, is contributing to the development of multi-speed economies. Indeed, it is a contributing factor to increased polarisation in regional economic performance (Figure 15, page 24).



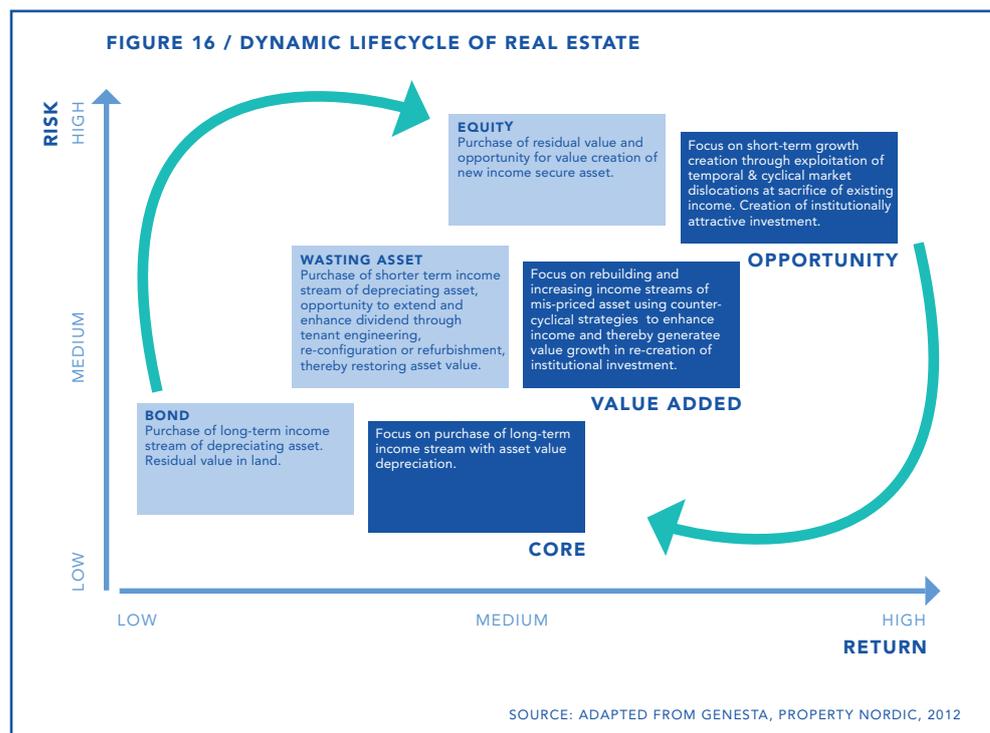
As discussed earlier, the narrowing focus of real estate investment has resulted in prime yields in the principal markets of a discrete set of perceived safe haven markets falling to levels last witnessed at the market peak. Yet prime rental performance expectations are weak. Given an acceptance that prime real estate yields will rise with bond rates in the medium term, this suggests investors expect low or even negative returns from investments. Yet, prime income secure assets in regional markets and in good quality sub-markets of principal cities remain high yielding. Considerably stronger returns are expected given the expectation that yields for these assets will compress even as bond rates rise and that rental performance will be stronger on an annualised basis over a five year forecast horizon<sup>14</sup>. However, the risk weighting associated with such investment is impeding the rational allocation of institutional capital.

Importantly, this will negatively impact on the contribution of real estate to the real economy, both directly and indirectly. First, through negative investment return reducing output, earnings and re-investment; second, a reduction in employment growth, particularly amongst lower skilled workers; third, the erosion of economic value add from the multiplier effect; and finally, it removes the possibility of beneficial positive externalities. This is greatly exacerbated by the accompanying focus on good quality, income secure assets.

<sup>14</sup> DTZ (2012) Outlook for 2013; Genesta Property Nordic (2013), 'The Duality of Mispricing' Nordic Insight, January.

## 6.2 Good quality, income secure assets

Real estate is unique in that it is one of the only financial assets that can transform its risk profile over its lifecycle in both directions (Figure 16)<sup>15</sup>. The same asset can be like both a bond and an equity depending on its ownership and/or risk profile. The leasing profile of an asset, including lease length, rental terms and the tenant’s covenant strength, is a key determinant of value and will change over time. By its very nature, a lease is a wasting asset with its value deteriorating from lease start to expiry. The perceived quality of a building also changes over time, with new regulations, innovation and changing business practices all impacting building performance and functionality over its life cycle. However, such assets also comprise a residual value into perpetuity, providing the potential to restore the lease profile.

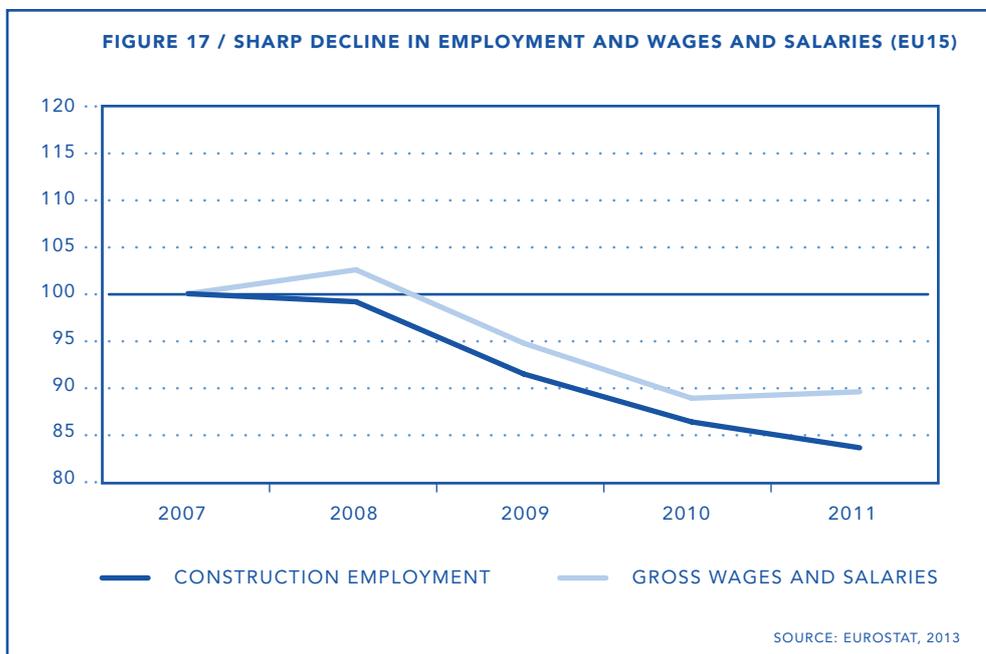


Historically, counter-cyclical institutional investing strategies have included the exploitation of real estate lifecycles. The acquisition of mis-priced prime, yet wasting, assets during the late contraction phase of the cycle affords the opportunity to implement tenant engineering and refurbishment strategies. These restore the leasing profile of such assets back to prime in time for the shift from market recovery to growth. Critically, institutional investors minimise downside risk by limiting such activity to strong locations, pre-leasing re-development strategies, and by adopting a rolling programme for tenant repositioning to diminish income risk<sup>15</sup>. The shift towards a more pro-cyclical investing strategy is leading to a dislocation in the real estate life-cycle, with low institutional demand for good quality assets with weak leasing profiles. However, the role of counter-cyclical investment strategies in re-cycling real estate investment assets is fundamental to the functioning of both the real estate market and the real economy.

<sup>15</sup> Genesta Property Nordic (2013), ‘The Duality of Mispricing’ Nordic Insight, January.

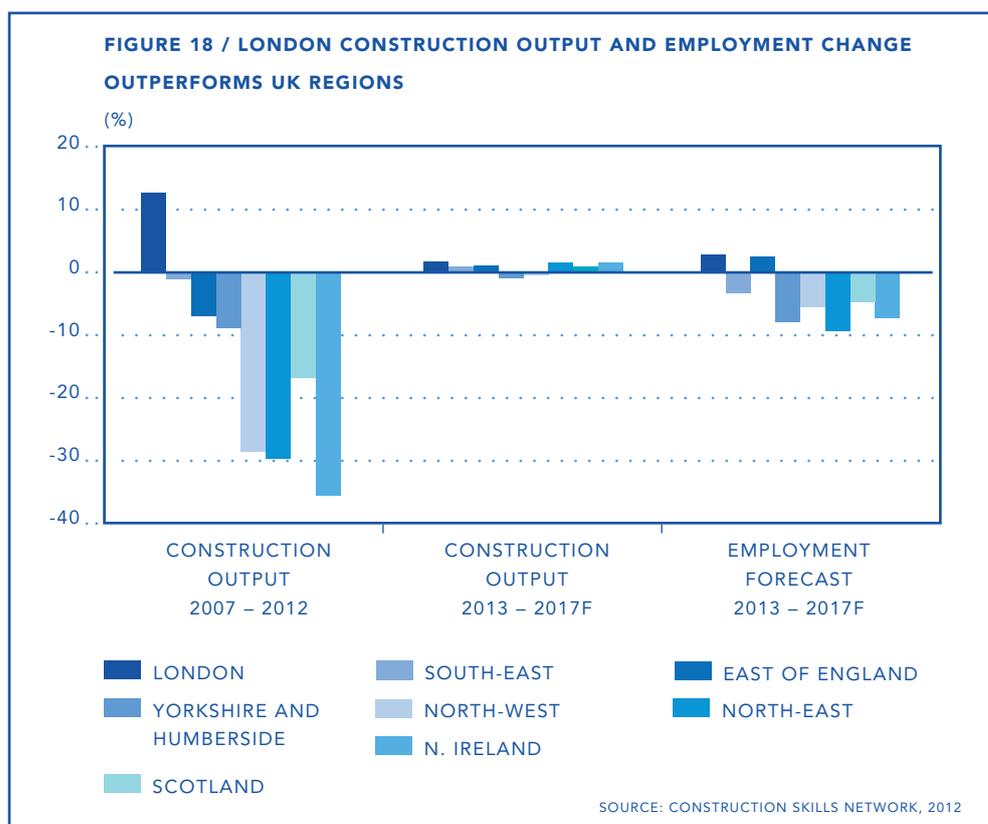
Institutional real estate investment in such assets triggers growth in commercial real estate construction and property management. Together these activities account for 93% of commercial real estate’s direct contribution to European GDP. Comparatively, prime income secure assets require much more limited capital expenditure and therefore are a lower stimulus for construction activity. As a result, the negative impact of proposed regulations on European GDP is multi-faceted. First, they will result in lower absolute allocations to real estate. This will significantly reduce the direct 2.5% contribution of real estate sector to European GDP. Second, the proposed regulations fostering of a narrow investment focus on low risk prime assets disproportionately diminish the indirect and induced contribution of real estate activity to GDP. Estimated to contribute an additional 4.5% of GDP, the erosion of the multiplier effect of real estate investment through construction activity is at least as concerning as the absolute fall in investment volumes.

Since the downturn, commercial real estate construction output has declined. This has been sharper than in previous recessions and its recovery has been slower. There is a paucity of timely data, but the most recent statistics indicate that in the UK, Spain and Germany investment in existing buildings and structures fell by 85%, 71% and 28% respectively between end 2008 and end 2010. Similarly, investment in new buildings and extensions fell by 14%, 68% and 32% respectively in the same markets over the same period. In the period 2010 to 2011, investment in European commercial real estate construction fell by 4.5%. Construction employment within the EU15 fell by 18.5% from end 2007 to end 2011, of which an estimated 60% are low-skilled workers with low alternative employment options (Figure 17). Average wages in the industry fell by 13% at the European aggregate. This results in a decline in disposable incomes, standard of living indicators and, in turn, has a negative impact on private consumption, even for those still employed in the sector.



Given uneven economic growth, with some economies remaining in contraction while others are in recovery and/or growth, it is perhaps unsurprising that the geographic dispersion of the decline in commercial real estate construction is uneven. For example, in the stronger German and Swedish economies construction output has recovered, employment in the sector has increased by 7.6% and 13.5% since 2007 and average wage growth has accelerated by 8.5% and 4%. Contrast with the Spanish economy where the industry continues to contract and where both employment and wages have fallen by just under 50%.

The narrow focus of investment in principal cities has also led to regional disparities within countries. For example, in the UK the regions experienced a sharp contraction in construction output between 2007 and 2012, while London continued to expand<sup>16</sup>. Such regional disparities are forecast to continue over the forecast horizon 2013 to 2017 (Figure 18). While output turns expansionary in most regions, over capacity in the industry and lower labour intensity of some public sector expansion results in further contraction in unemployment. Commercial real estate accounts for 22% of total activity and low institutional investment in the regions will further accelerate regional disparities in output. Moreover commercial real estate is a labour intensive sector and low investment will disproportionately impact upon employment rates. In addition, it will impede the creation of employment in property management and services in regional markets. The resulting downward spiral of decline in suburban and regional economies will lead to lower inward investment, in turn lowering measures of sustainable economic growth.



<sup>16</sup> Construction Skills Network (2012) Blueprint for construction 2013 – 2017, CITB.

## 6.3 Low or no development risk

The contraction of the construction sector reflects the severity of the financial crisis. However, it is exacerbated by proposed regulation. The effect of Solvency II and IORP II has already skewed institutional investment towards pro-cyclical strategies requiring minimal asset management or construction activities. At the same time, new regulations embedded within Basel III require bank lenders to de-leverage, improve capital ratios and simultaneously, reduce balance-sheet risk exposure. While all risk weightings relating to real estate lending have resulted in lower availability of capital and a higher marginal cost, risk weightings ascribed to development finance are prohibitive to its issuance.

The scarcity and higher marginal cost of real estate lending and development finance in particular prevent private investors from exploiting such counter-cyclical opportunities in the absence of institutional investors. They also impede property development further up the risk curve by property companies and more opportunistic investors who historically provide institutional investors with income secure assets and deliver appropriate space to occupiers. This deteriorates the quality of invested stock and accelerates the rate of real estate obsolescence.

Ultimately, this results in a lack of appropriate business space. Excess occupier demand for good quality assets will force occupiers dependant on this factor of production, including many SMEs, to owner occupation rather than leasing. Being capital intensive and fixed assets, this will reduce business productivity and growth. New and growing business will lack the flexibility and agility in location and employment dynamics required to maximise new opportunities. It also ties up available capital, lowering the potential to invest in business expansion and/or R&D activity. Critically, business space shifts from an investment asset to a product of consumption and therefore, beyond its purchase, does not contribute to the real economy.

Real estate investment is pivotal to longer-term asset-liability duration matching, enabling the longer-term funded status of pension funds and insurance companies to be secured. While critical to the stability of the economy, the indirect benefits of institutional real estate investing to the real economy are fundamental to an efficient market economy. Investment in the sector provides a vital component of the infrastructure required to facilitate economic growth. As such, it represents a factor of production. Any proposed regulations impacting on the volume, timing and destination of real estate investment must take into consideration their impact on economic performance absolutely and its regional distribution.

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