BAYFIELD | REAL ESTATE STRATEGIES

Rents, deductions and forecasts

Introduction

Forecasts set expectations for future levels of income, capital and total returns. These forecasts may be for annual return estimates, or of long-term performance expectations.

The most common datasets used for forecasting across European markets are City level prime rents and yields.

A simple income return estimate can be made using the net (of irrecoverable expenses) prime yield and a simple capital growth estimate can be made by adding the impact of the change in yield on capital values to the percentage change in prime rent.

Achieved returns on held properties will also be affected by incentives and depreciation.

When income returns are low and rental growth is muted; irrecoverable costs, incentives and depreciation become significant determinants of returns.

But do forecasts reflect return expectations after deductions, or are they a pre-depreciation, pre-costs, hypothetical, indication of market trends? If so, was this intended?

RES and Bayfield Training surveyed 19 respondents across 16 organisations to ascertain the range of forecast inputs across Europe and the approaches taken to revenue and capital deductions.

Survey respondent organisations

Aberdeen Standard	CBRE	Goodbody	PFR
AEW	Cushman and Wakefield	Invesco	PGIM
Barings	DTZ	LaSalle	QuadReal
BNPP	Fidelity	Nuveen	Savills

Prime or average rent?

There are two common measures of rental trends: the average movement in all rents and the movement in the prime rent.
Prime rents are either the hypothetical best rent achievable or based on the top (say 1-5%) of all lettings.
Average rental growth is a weighted average of rent or rental value movements in a market.

The first question in our survey was whether organisations are forecasting using historic series of prime or average rents. The most common rent data used in forecasting by far is prime (17), with only 2 respondents forecasting using average rent inputs.

When forecasting rent, do you use prime or average rent figures?
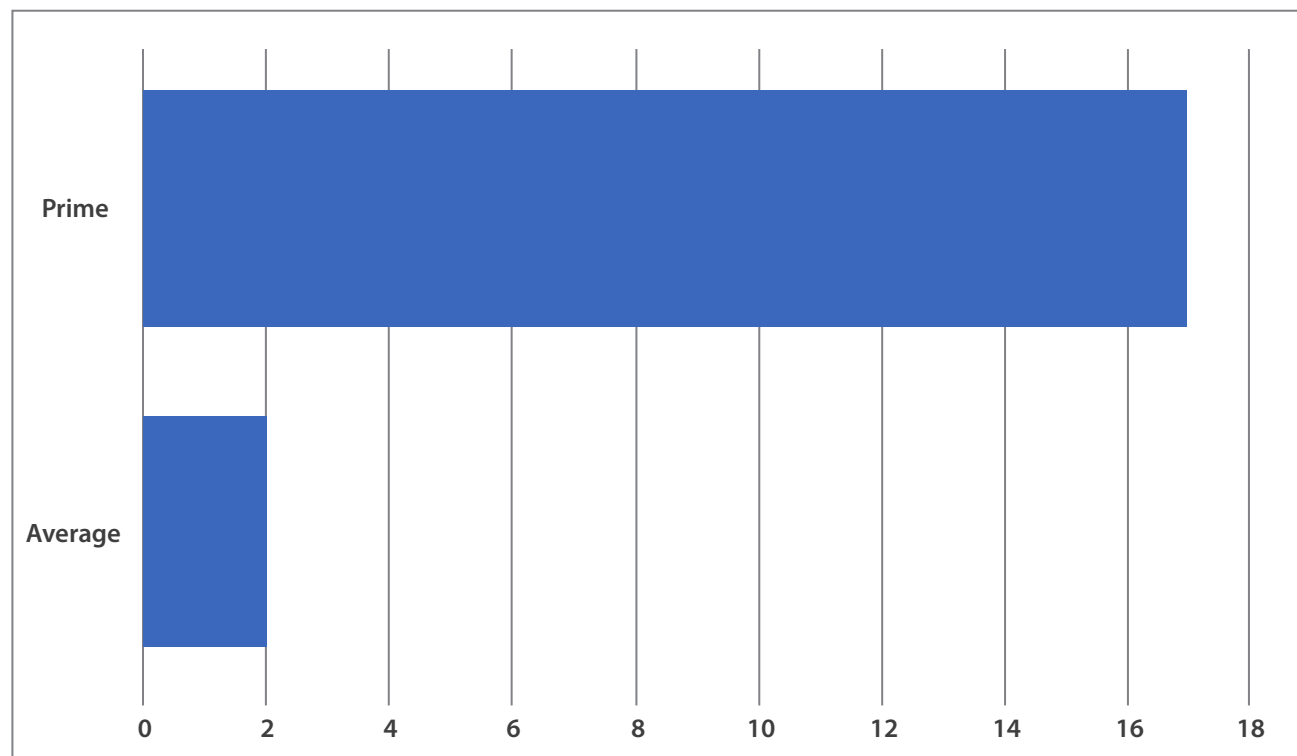
Rental definition

Forecasters have a choice in the quantum of revenue and capital deductions that they make to return forecasts.

An estimate of income return (yield) using a prime rent may or may not deduct incentives and / or have an allowance for irrecoverable costs. Understanding the basis of the prime rent in the net yield is therefore crucial in estimating an expected income return. Excluding or under-estimating irrecoverable costs risks overstating the attainable income return.

The danger of calculating capital growth based solely on changes in prime rents and yields is exaggerating achievable capital growth by ignoring depreciation.

To illustrate, data from the MSCI PICA service for the central area of Stockholm (provided by one respondent) shows significant irrecoverable costs and capital expenditure.

PICA:

	Stockholm Central area SEK m²	
Total charge(incl. service charge)	**3,019**	
Recoverable revenue costs	368	12%
Gross Rent	**2,651**	
Property taxes	110	4%
Gross income	**2,541**	
Irrecoverable revenue costs	314	12%
Net Operating Income	**2,227**	
Less capital expenditure	654	29%
Net Cash flow	**1,574**	

The majority (12) of respondents forecast only gross or net (of property taxes) rent, although two of these respondents specifically stated that cost and incentive deductions are made in asset appraisals.

Three respondents that did make adjustments for costs, made deductions for both irrecoverable revenue and capital costs.

The two respondents using average rents deducted for incentives and both irrecoverable revenue and capital costs.

Which of the following definitions of rent do you forecast?
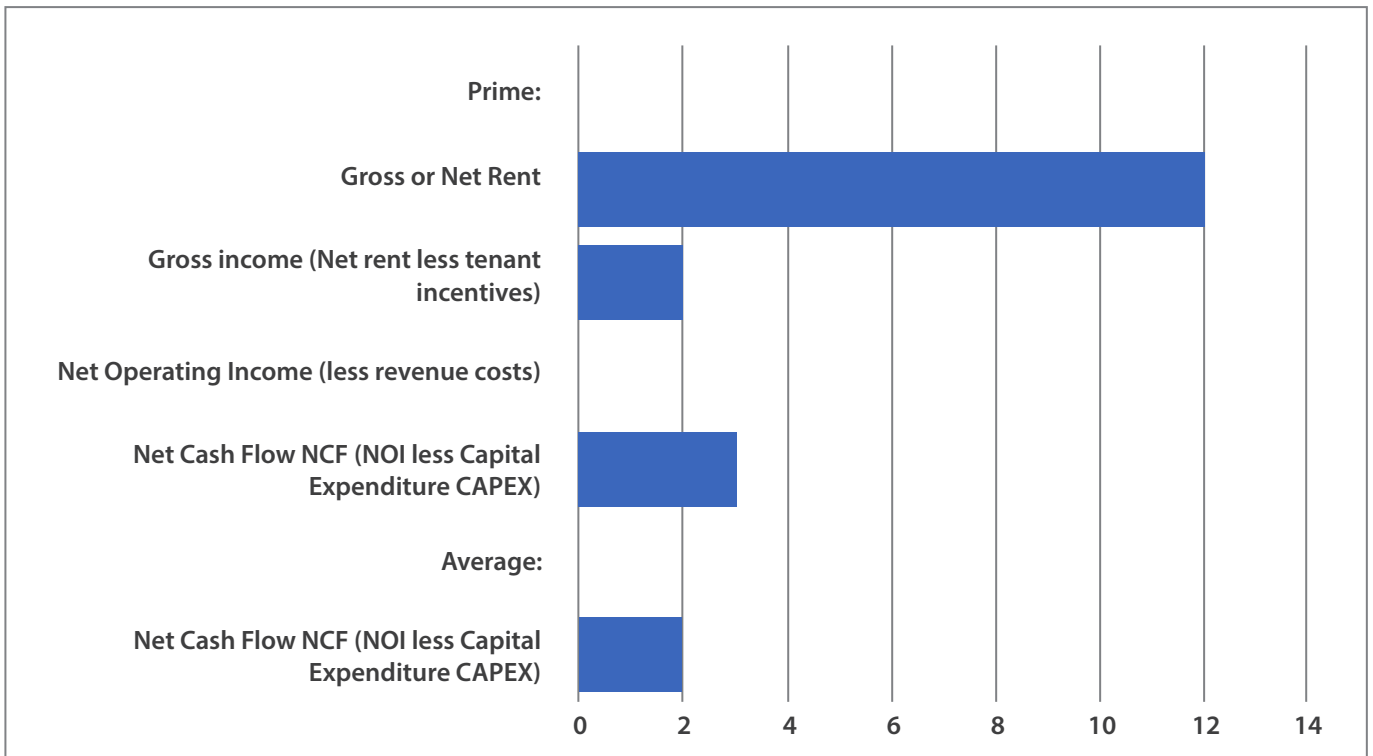
Sources of rent data

Understanding the definition of the rent in a forecast depends on the documentation provided.

Of the respondents, 14 were sourcing either broker data direct (a couple mentioned PMA which I have classified as broker data).

Forecasters wishing to be consistent in whether cost deductions are, or are not made, are inhibited by variations in definitions of rent between countries, sectors and providers. This difference is most crucial in the definition of the prime net initial yield: what is the numerator (the rent) net of?

The alternative databases for prime rent data were a mix of Immostat, NVM, Property NL, company report and accounts and companies own lettings database.

One respondent using average data referenced MSCI, the other their own letting database.

From where do you source the rent selected?
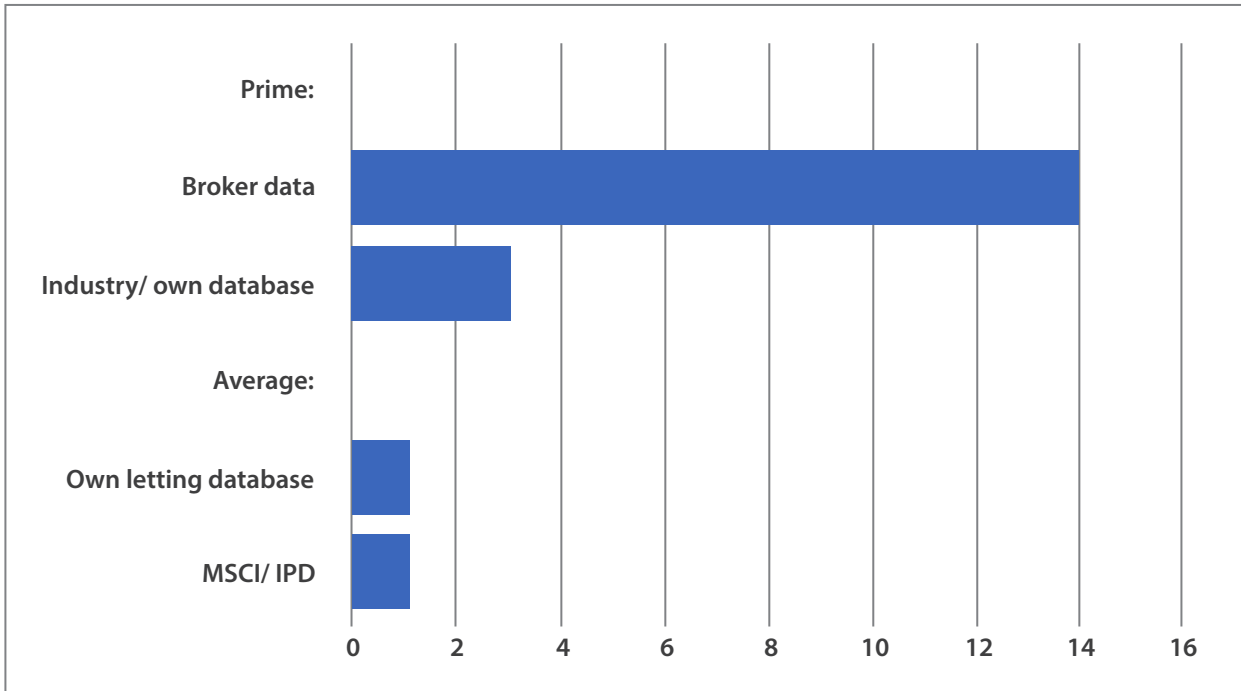
Sources of deductions

Respondents sourced prime tenant incentives from a mix of sources including agents, internal databases and industry databases.

Respondents using average rents sourced inputs from both their own letting databases and MSCI.

Two respondents stressed the separation of the forecasts of prime rents and yields from the cost assumptions made by the underwriting team.

Please tell us about the sources(s) of the data you use:
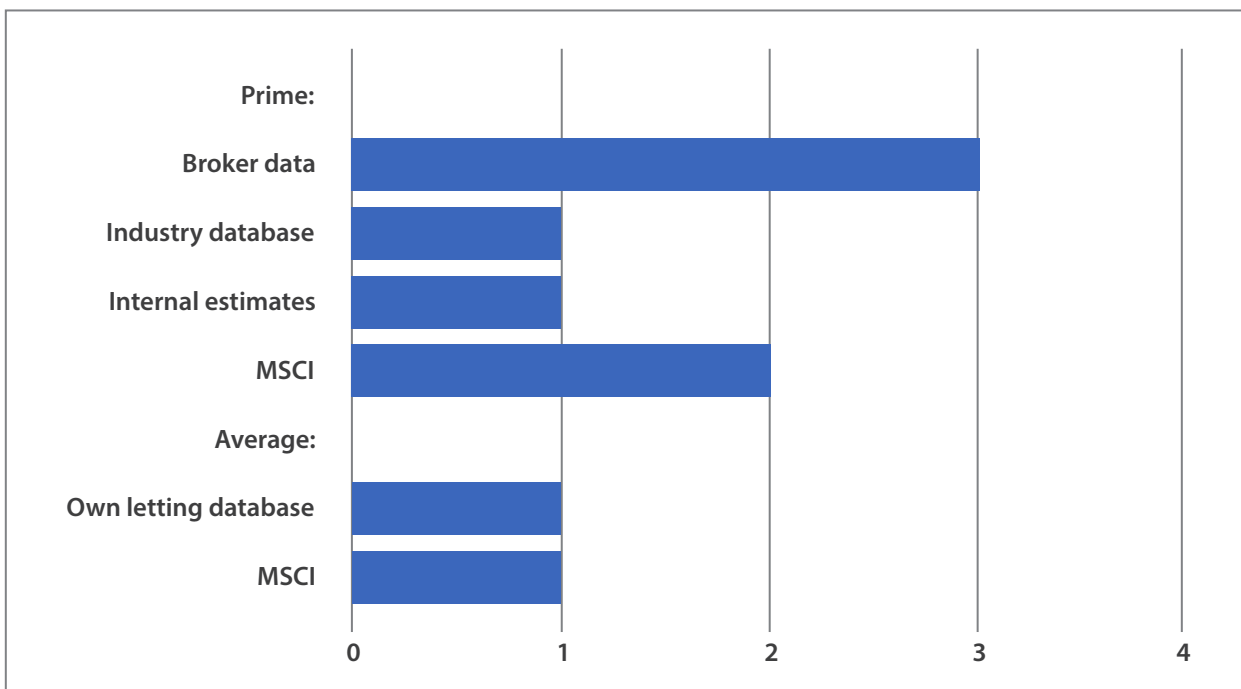
Discussion of estimates doe deductions

Prime rents are the dominant source of data for forecasting rather than data on held property, so where can empirical estimates of costs be soured?

Irrecoverable revenue costs

MSCI publish net operating costs as a percentage of gross income and improvement expenditure.

The MSCI definition of irrecoverable costs is *"non-rental costs incurred for the day-to-day operation of a property, which cannot be recovered from its tenants (utilities, insurance, (property) taxes, maintenance, management and letting)".*

It is my understanding that this definition includes ground rents which rather inflates the UK figures.

The MSCI figures for irrecoverable expenditure by sector range from 25% for retail in some Nordic countries, to less than 10% in France.

An alternative source of data on property costs are the INREV and AREF Property Expense Ratio and the AREF (assuming investors can gain access to the reports):

Ratio	AREF	INREV
Property expenses (D) **(and ratio)**	Property portfolio specific costs including: • Non-recoverable property management fees • Service charge shortfalls and holding costs such as empty rates and security • Rent review and lease renewal costs • Maintanance and repairs (not improvements) • Property insurance costs/ rebates • Amortised debt financing fees/ costs • Debt valuation fees • Marketing of vacant space • Project management fees (where not capitalised)	• Property management fees • Service charges shortfall • Letting and lease renewal fees • Property insurance • Acquisition/disposal related costs • Debt financing fees • Debt valuation fees • Development fee • Marketing of vacant space • Project management fees - development • Taxes on properties (exl transfer taxes not embedded in Nav)

Comparison of the ratios

The calculation of the ratios described above the shown in Calc

Caculation 1 - arriving at the key ratios Management fees where applicable	(A)	x
Other vehicle and overhead	(B)	x
Total (A+B)	(C)	x
Property level costs	(D)	x
Total (C+D)	(E)	x
Gross Asset Value	(F)	x
Net Asset Value	(G)	x
Gross rents	(H)	x
Ratios:		
INREV TER[2] and AREF TER[3]	C/F and C/G	
INREV REER[4] and AREF PER	D/F	
AREF REER	E/F and E/G	
EPRA Cost Ratio	E/H	

Cost Transparency in European Listed and Non-Listed Real Estate Consultation Paper December 2016

Improvement expenditure

The MSCI data for improvement expenditure by sector average around 0.7-0.8% y/y as a percentage of average capital employed.

No deductions for prime?

An alternative view expressed in the surveys was that irrecoverable and capital costs are de-minimis for new and fully let buildings. To explore this view, the table below disaggregates the MSCI UK data for regional offices by property construction date.

MSCI Net Operating costs, last 15 years, % of gross income

	Rest of UK offices
>2010	14.8
1995-2010	10.2
1980-1994	15.4
1970-1979	23.8
1940-1969	19.5

Whilst there is some evidence that irrecoverable costs rise slightly as building age, costs are far from zero for new buildings. A breakdown of these costs would assist in explaining this pattern by building age.

The results for improvement expenditure are a little bemusing with the highest costs on the newest buildings. Again, a breakdown of these costs would be helpful: are these capital payments to tenants or residual development expenditure?

MSCI improvement expenditure, % of average capital employed, 2010-18

	Rest of UK offices
>2010	3.1
1995-2010	0.6
1980-1994	1.5

More disaggregated results have been found by NCREIF, with average building improvement expenditure as a percentage of NOI rising only for buildings over 20 years old.

EXHIBIT 12: NON-LEASING RELATED CAPEX REQUIREMENTS ALSO RISE WITH AGE

Hines CapEx Get it Right or Mis-underwrite - Exhibit 12
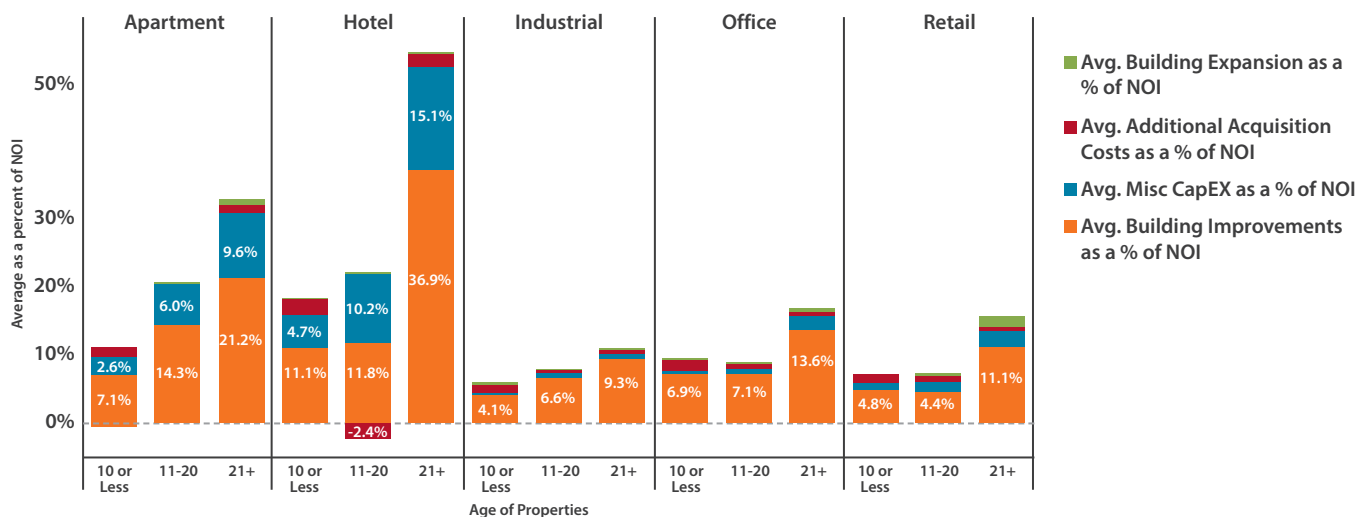
Depreciation

The vast majority of respondents are using prime data. The danger of calculating capital growth based solely on changes in prime rents and yields is exaggerating achievable capital growth by ignoring depreciation.

In the long-term, the growth in achieved rents on a held property would not be expected to match that of the growth in prime rents due to deterioration and changes in functional, aesthetic and legal tenant requirements.

To account for this expected depreciation, a deduction can be made to the capital growth forecast based on the empirical gap between past rates of prime and average rental growth for the same location (where such a series exists). For example, the growth in CBRE prime rents for West End offices since 1984 has exceeded that recorded by the MSCI Index over the same period by 0.4% y/y.

One difficulty of using such a calculation is choosing the measurement period; in our West End example the gap between the prime and average rental growth rates was as high as 2.8% y/y if measured to 1996. Over short time periods the gap can even become negative, as found in 2010 by the IPF in Depreciation of Office Investment in Europe.

Depreciation of Office Investment in Europe, IPF, March 2010

	Rental depreciation
Amsterdam	-0.4%
Dublin	1.7%
Frankfurt	4.9%
London: City	0.4%
London: West End	2.2%
Paris	-1.3%
Stockholm	-2.0%

A contributary cause of these results is likely to be that rental movements can vary significantly for properties in different locations and of differing quality, both at different points in the rental cycle and over longer time periods.

The average movement in all rents will therefore mask significant differences in rental movements across individual buildings. This problem is compounded if comparing average rental movements with rental movements of not just one building, but the best, perhaps hypothetical, building in that market.

The current position for retail is an extreme and timely example, with rental trends for the very best shops and shopping centres deviating widely from the travails of the vast majority of retail properties.

A breakdown of rental movements across different locations, quality bands and size bands to identify such differing market trends does not solve this problem, but at least highlights the variations in rental growth.

Other points raised

One respondent stressed the importance of stripping out inflation and concentrating on real levels of growth.

Conclusion

The most common datasets across markets are 'prime', so unsurprisingly they are favoured by forecasters looking for the longest data series with the most frequent and timely updates.

But systematic differences in cost characteristics across markets will render headline level comparisons of prime returns inconsistent, favouring markets with relatively low levels of cost deductions.

Ignoring deductions places all the emphasis on forecasting future turning points in rents and yields and less on the actual level of returns.

This approach may be justified if underwriters adjust individual property returns for depreciation, vacancies, incentives, irrecoverable and capital costs based on the individual property characteristics.

Alternatively, market forecasts can be adjusted for average incentives, irrecoverable costs and capital costs – a return that would mimic the MSCI/NCREIF/INREV property level total return indices.

If the industry is to use data from indices constructed from actual properties then these organisations should assist by publishing series clearing disaggregating the costs to ensure no double counting in deductions.

For example, splitting out incentives from capital costs and splitting out ground rents from irrecoverable costs.
Prime data providers could also be clearer on their definition of prime rent and net initial yield, what is included in the prime rent and what is the cost deduction.

We would suggest the following breakdowns:

Measure
Total charge (incl. service charge)
Less recoverable revenue costs
Gross Rent
Less property taxes
Net Rent
Less tenant incentives
Gross income
Less irrecoverable revenue costs
Less ground rents
Net Operating Income
Less capital expenditure
Net Cash flow

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