Global Perspectives

Report by the RICS Investment Risk Forum

Perspectives on Global Real Estate Investment

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Report by the RICS Investment Risk Forum

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Global perspectives

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About this report

This report offers the perspectives of global real estate investors on the theme of risk management. It is based on the insights of the **RICS Real Estate Investment Risk Forum (IRF)**, a network of more than 40 senior investors from many of the world's largest real estate investment businesses.

Collectively, members of the IRF and their firms represent more than US$1tn in real estate Assets Under Management. The group was established in 2015 to foster industry leadership and to share best practice, with the aim of enhancing the industry's approach to risk management.

This report, the first by the group, draws on responses to an anonymised sentiment survey, Global Investment Risk Perspectives 2017, which ran during May 2017, along with follow-up interviews. Further context is drawn from IRF roundtables which have been held regularly in London, New York and Singapore since September 2015. The insights in this report are drawn from a total sample of 55 senior investors.

The report aims to highlight some of the trends and perspectives which influence risk management in real estate investment. It is designed to stimulate further discussion and to act as a foundation for ongoing leadership in this field.

Disclaimer

The findings in this report reflect broad themes emerging from the RICS Real Estate Investment Risk Forum (IRF). Content in this report is not attributable to any one individual or business. It should be noted that perspectives on all issues vary across the group.

The IRF comprises the following participants:

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Part 1: Introduction

1.0 Executive summary

In recent years, the real estate investment industry has seen an improvement in the way it manages risk, according to investment leaders from around the world. Investors representing more than US$1tn real estate Assets Under Management agree that the financial crisis acted as a catalyst for positive change in the way risk management is viewed and applied across the sector.

During the current cycle, many real estate investors have built their risk management infrastructure and developed their operations in this area. This includes, amongst other things:

- Growing their risk management teams, internationally
- Greater integration of research within their risk management processes
- Introduction of new quantitative modelling techniques
- Acquisition of new in-house skills and expertise, in part reflecting portfolio diversification
- Drives to improve internal knowledge sharing.

Despite these advances, several challenges continue to undermine efforts to improve risk management approaches today. Chief amongst these are concerns surrounding the availability and consistency of cross-border property data, a challenge which is becoming more acute as the industry grows internationally and especially as investment volumes grow in emerging markets.

Advances in risk management have come at a time when real estate investment has reached new all-time highs; a time when yields have been compressed and competition for returns fierce. Against this backdrop, investors are observing a growing risk appetite, with moves into alternative assets becoming increasingly widespread.

Investment risk management is predominantly seen as being driven by investment performance motivations, rather than compliance. However, respondents to this survey identified 16 regulatory systems, highlighting the breadth of external influence on risk management within the sector today.

In 2017, the sector appears much better placed to manage and mitigate risk. Experiences of the last downturn have prompted material changes in the way investors are set up to weather complex and volatile markets. However, there are several areas which the industry needs to tackle to improve risk management:

1

The industry needs to do more to ensure quality, comparable real estate market data is available across borders.

2

There is a need for greater leadership, and best practice in risk management systems and processes, drawing on lessons from other investment sectors.

3

The industry needs to improve institutional knowledge-sharing to ensure new generations learn from the experience of previous cycles.

2.0 Chair's foreword

In the two years since the RICS Real Estate Investment Risk Forum (IRF) was founded, I've only grown more convinced of its value to the industry, to investors and to the public at large.

The group, which was established during my term as the 134th RICS President, sought to meet a growing desire amongst investors for a forum dedicated to advancing risk management thought leadership and best practice.

It was initially a one-off meeting of responsible business leaders, but it quickly became clear that there was a collective will to take a sustained and more public leadership role.

Today, ten years on from the Global Financial Crisis (GFC), there are legitimate concerns that some lessons of the past have been forgotten or overlooked by some in a rush to deploy growing volumes of capital. More worryingly still, despite the cyclical nature of our industry, there have been moves to re-cast real estate investment in a new, post-GFC paradigm – one which is somehow immune to the risks and mistakes of the past. For businesses represented on the IRF, the adage that "it'll be different this time" acts only as a further incentive for collective leadership.

It is against this backdrop that the IRF continues to meet regularly, and remains the only group of its kind convening senior real estate leaders from around the world to discuss investment risk – and how to mitigate the vulnerability of real estate portfolios to external shocks in our rapidly changing and uncertain world.

Today, on behalf of their firms, IRF participants are collectively responsible for more than US$1 trillion of real estate Assets Under Management (AUM), with investments across all real estate classes. Our fiduciary duties extend beyond our own investments, though. Real estate is a store of up to 70% of the world's wealth[1], it touches every aspect of people's lives from the homes and offices they live and work in, to the pensions and investment savings they rely on. Functioning and sustainable real estate markets matter, and they matter to us all.

The IRF has a vital role to play in sharing examples of risk management best practice, while also being honest about where problems lie and what the industry can do better. We want to foster new thinking and approaches to risk management, learning from each other and from other fields of investment. Our goal is to shine a spotlight on good practice and in doing so, bring greater confidence to the marketplace and to all users of real estate.

I hope this report will stimulate debate on how risk management should evolve in the future to enhance credibility and confidence in our sector.

Martin J. Brühl FRICS
IRF Chair
Chief Investment Officer, Union Investment Real Estate
RICS past President (2016/17)

1 According to a World Bank sponsored report by the Land and Real Estate Assessment (LARA) network.

3.0 The role of risk management in real estate investment

When property values fell by around 30% in the United States and Europe during the 2007/8 Global Financial Crisis, there was a sense of "here we go again" for those of us who have been in the industry for any length of time – in my case nearly 30 years.

Philip Barrett
Global Chief Investment Risk Officer, PGIM Real Estate

Over this time, we've lived through periods of market distress in the early 1990s, the Asian Crisis in 1998 and the Dot Com downturn in the early 2000s. The cyclical nature of our business once again surprised a new – and some of the old – generation of real estate investment professionals as the capital market movements crushed the more predictable income returns that real estate can deliver.

The response to the GFC was a raft of legislation and regulation on financial industries. These included real estate investment management, with the Alternative Investment Funds Management Directive (AIFMD) of 2011 bringing in specific conduct of business requirements around risk management in Europe. Applying this directive, which was aimed partly at bringing further disclosures to the hedge fund and private equity industries, to real estate investment management proved challenging. But it was clear that there were now more specific rules and guidelines to risk management and that this area was going to get more attention at the board level of all private fund management businesses.

Real estate is a complex and relatively illiquid market. It is important to remember that, in our industry, our clients ultimately pay us to take risks on their behalf. Good risk management means evaluating the risks specific to each investment opportunity, understanding any mitigating factors and then assessing the expected return to determine if it compensates for the risk being undertaken. At the portfolio level, it is about understanding how these risks have aggregated to either increase or reduce their likelihood and impact.

A robust risk management framework does not just look backwards but also looks to the future. It concerns itself with both the long-term secular drivers of our business, such as demographics and urbanisation, as well as disruptive technologies, such as artificial intelligence and driverless cars. We consider the potential impact of these on the business of bricks and mortar.

The pace of political change has accelerated in recent times and the noise around these events has amplified. This makes understanding the implications on our industry, which invests for the long term, challenging. As the period of time since the last market distress lengthens, real estate is now entering a period of below trend returns. Concerns about the low level of core investment returns is leading investors to move up the risk curve into secondary cities/countries or alternative assets. Risk management departments need to be alive to the increased risks that are now being taken.

The real estate investment management business has been accused in the past of making long term investments with short term memories. The increased focus on risk management being supported by the IRF will hopefully be the start of addressing this criticism.

4.0 Real estate investment in the global economy

Simon Rubinsohn
RICS Chief Economist

As we reach the tenth anniversary of the onset of the Global Financial Crisis, it is intriguing to reflect on how we build a durable, sustainable and inclusive recovery. The OECD concluded its June 2017 meeting by recognising the world remains some way from escaping "fully from the low growth trap" while Christine Lagarde continues to refer to "the new mediocre".

Critically, because of the legacy of the GFC, monetary policy remains hugely accommodating as has been the case for much of the past decade. This stance has been channelled through a combination of low interest rates and quantitative easing (bond purchases). And while the US Federal Reserve has begun to shift direction, nudging up its key short-term rate higher, there is no sense that other central banks are following suit. Indeed, markets around the globe remain of the view that the interest rate cycle will continue to map out a very different path from the past with a much lower peak point.

The impact of this extended period of cheap and easy money on the real estate sector has been profound. Having fallen dramatically during the first half of 2008, commercial property transaction volumes remained subdued for the next couple of years before beginning to rebound. Such was the extent of this turnaround that, by 2015, the global level of activity had climbed back to within a whisker of its pre-GFC high. Subsequently, transaction volumes have slipped back somewhat although this is partly a response to the strength of the preceding recovery.

Alongside this upswing in activity, cap rates have been compressed as investors have been increasingly attracted to real estate, particularly in prime locations, where supply has struggled to keep pace with this interest. Property in many major markets is now trading on yields well below historic averages and in some cases, close to all-time lows.

The recovery in both confidence and transaction volumes has predictably been accompanied by a more substantial uplift in cross border capital flows around the world. Over the past few years, the latter have been running at somewhere between 40 and 50% of total volumes, according to JLL, which compares with less than one quarter in the immediate aftermath of the GFC.

One particularly notable feature of the last decade or so has been the rise of Asia-Pacific in the commercial property space, which has mirrored its increasing economic power. CBRE research suggests that this regional bloc now accounts for around one-third of public real estate investable stock compared with less than a quarter in the years prior to the onset of the GFC.

That said, the top city destinations for overseas capital in 2016 remain the more established centres like New York, London, Paris and Amsterdam. For Asia, Hong Kong, Singapore, Shanghai and Seoul continue to attract the strongest inflows albeit still some way off the biggest markets.

5.0 Theme 1: Risk management after the Global Financial Crisis

5.1 Risk management has improved since the Global Financial Crisis

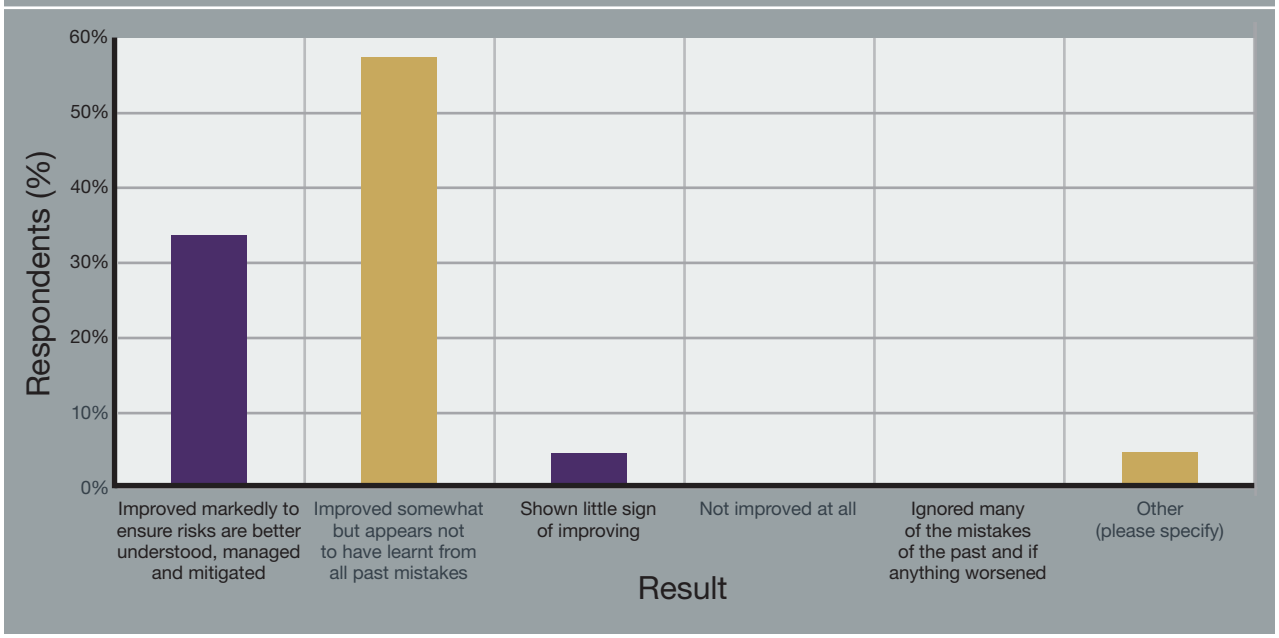
The 2007/8 Global Financial Crisis remains in the minds of investment managers, prompting an increased focus on risk management over the last ten years. However, investors are balancing this with a need to achieve returns. With some investors believing that we're nearing the top of the cycle, several are moving further up the risk curve to achieve them.

- The results show that 90% of respondents believe the industry's approach to risk management has improved since the GFC. 33% believe it has **improved markedly**, while 57% believe it has **improved somewhat**.
- One respondent believes it has shown little sign of improving, while another respondent thinks it's too difficult to assess during a 7-year up cycle.

The feedback from respondents demonstrates that a clear majority believe risk management has improved in the industry since the GFC. However, there is still some way to go before investors and the public can be confident that the industry reflects the gold standard in terms of risk management.

33% of respondents believe the industry's **approach to risk management has improved markedly** while **57%** believe it has **improved somewhat.**

In the period since the Global Financial Crisis, do you think the industry's approach to risk management has:



Here are five areas that investors said have improved:

1

More prudence from banks in lending reviews

2

Investors having more robust processes and monitoring in place

3

Remuneration packages more focused on long-term returns

4

Greater focus on real estate risk management from regulators

5

Risk management now at Board level, with dedicated teams. One risk manager noted that *"my role didn't exist before the financial crisis, so there's clearly been a shift".*

> *Our clients want us, and pay us, to take risks because, in today's environment, so called 'risk-free' investments produce no or even negative returns. It is therefore of utmost importance that we identify the various sources of risk, and that we prioritise and mitigate them. Investment management is risk management.*
>
> **IRF member (London)**

More people in the industry want to talk about risk management than ever before. Nevertheless, there are still relatively few people in the market who are purely focused on managing risk. It is also hard to hire and build teams with this specialism: *"More people want to talk about risk management than any time before. But I've been struggling trying to hire people into my team, because so few candidates are focused on risk."*

This is supported by the survey data which shows that most organisations who responded (55%) have 1-5 employees directly involved in the risk management function. This was defined as roles with an explicit risk management undertaking.

5.2 Risk management processes are largely driven by performance

Respondents told us that their risk management processes are primarily driven by performance (57%), with 24% driven by compliance. Other drivers include: investors' expectations, business philosophy & culture, or 'delivering the best in class risk management solutions for our clients.'

There was no apparent geographical divide for the risk management drivers in organisations. The push is primarily coming from performance, with investors recognising improved risk management processes strongly link to improved returns.

However, there is also clearly more of a focus from regulators on improving risk management in real estate investment. This is apparent globally, with a few examples including:

- The Bank of Japan specifically talked about concerns surrounding the fast-growing real estate lending market in their Financial System Report (Apr 2017);
- The UK's FCA issued a consultation paper about open-ended property funds and risk management. Their findings are due later in 2017;
- The US Federal Reserve noted, in their Monetary Policy Report (Feb 2017), that commercial real estate valuations are an area of 'growing concern';
- The Monetary Authority of Singapore, along with several other Asian banking regulators, have been vocal about real estate valuations and introducing macro-prudential measures to limit the impact – particularly how valuation deterioration might affect the health of the banking sector – in their Financial Stability Review (Nov 2016).

> *"It's not just about improving portfolio management – the regulators are also driving this change."*
>
> **IRF member (London)**

5.3 Risk management is interdisciplinary

The survey asked for definitions of risk management – here are a few examples that reflect the sentiments of respondents:

- *"Risk Management is an interdisciplinary process of identifying, measuring and controlling the impact of 'uncertainty' in the investment process onto the expected return of an investment."*
- *"Investment risk management should aim to be 1) Deliberate to ensure that only desired risks are taken while undesired risks are avoided, 2) Diversified, to be efficient, risk taking needs to be spread across the investment universe, 3) Scaled, levels of risk need to be consistent with the target returns and the risk-bearing capacity of the client. When investment risks are understood with confidence, risk takers can be more decisive."*
- *"Investment risk management is a key process by which our organisation seeks to protect our clients from undesirable outcomes as it works to deliver their investment objectives within agreed risk tolerances."*

The survey findings strongly reinforce the interdisciplinary nature of risk management. 67% of the respondents told us that research was integral to their risk management approach, with a further 24% saying that some consideration is given to research. Only 10% run their risk management process independently of research. Research was seen by some as a tool for analysing, and assessing the impact of, emerging risks.

One respondent noted that: *"Real estate can learn from other investment sectors where risk management is often run as an independent division."*

6.0 Theme 2: Availability and accuracy of data

6.1 Inconsistent or poor quality data is a major challenge for risk managers today

Despite global property investment volumes reaching all-time highs in 2015[2], the findings highlight a lack of quality benchmarking data in many markets.

More than half the respondents agreed that inconsistent property data reporting is a major challenge today. A particular concern was its impact on their ability to accurately compare asset, portfolio and fund-level performance between countries.

Even among those that were less concerned about data availability and accuracy, there was a consensus that more robust and comparable datasets would only be a good thing. One respondent noted that: *"While not a major issue for our business today, data standardisation will definitely help investors in all aspects of their risk management".*

Typically, respondents that were less concerned about data inconsistency were limiting its impact by focusing on markets where they could achieve at least a minimum level of data certainty.

Investors offered a long list of data sets and indices which they felt were lacking or inconsistent across global markets today. Some of the more commonly identified were: transactions data; rental growth; yields; covenant data and valuations.

For respondents that identified data inconsistency as a major challenge, two issues came to the fore:

1 Availability and quality of data is patchy

2 Data comparability is poor across markets

> *Data availability is still one of the key issues when it comes to both investment decisions but also risk management of a portfolio.*
>
> **IRF member (Singapore)**

> *The quicker real estate can achieve sensible benchmarks in Asia, Europe and the Middle East then the better placed we will be to effectively manage risk.*
>
> **IRF member (London)**

2 Real Capital Analytics Global Capital Trends Report, Q1 2017

80% of Asia-based respondents said data inconsistency was a major problem for risk management today.

> *The challenge is not new, but as people invest more globally, it becomes more transparent just how non-transparent it is.*
>
> **IRF member (London)**

6.2 Availability and quality of data is patchy

Access to, and quality of data is heavily market dependent. Several respondents noted that in many countries the data they are looking for simply does not exist, or the quality and reliability of data available to them is poor. For many this was a key factor in deciding whether to invest in a market.

Regional differences

The Asian continent in particular is viewed by investors as lacking in the data available. In part, this was attributed to its relative immaturity as an investment destination for international institutions, when compared with Europe and the US. However, several respondents noted that as Asia continues to dominate the global share of commercial property investment, the need for quality benchmark data will only become more important.

One investor noted that, *"for the China market, reliable data is currently limited to Beijing and Shanghai Central Business Districts only"*.

The UK and US markets are seen as leading the way in the amount and quality of data available to investors, with the US said to offer *"far greater levels of transparency"*. For investors managing property portfolios exclusively or largely in these markets the challenge of data inconsistency was less of an issue.

Not all investors are compromised by a lack of market data, even in parts of the world that are considered to rank poorly in terms of transparency. Some can access information such as transactions data through their affiliations with local agents and brokers. However, even in these cases, the data can be based on in-house methodology and is not always reflective of other local market indicators or definitions.

6.3 Data comparability is poor across markets

Where data is available there is no guarantee it will be easy to interpret and compare across borders. Several respondents noted that domestic systems and standards for collecting and reporting real estate market data can be sophisticated but vary dramatically from one country to the next. Some will factor in taxes or transaction fees, for example; others will not. Some will report trends over monthly or quarterly timeframes; others might be annual. Some datasets will be generated through detailed and transparent methodologies; others will be more subjective and less prescriptive.

These datasets may have developed over many years and become valuable sources of insight at the domestic market level, but they can cause problems when trying to benchmark against similar information elsewhere. For many global investors, this can add to the challenge of managing risk prudently.

Valuation is just one piece of the data jigsaw, but several respondents highlighted its importance in managing asset and portfolio-level risk. Being able to access reliable and comparable valuations is extremely beneficial to investors. However, achieving this is seldom straight forward, with numerous valuation standards and approaches in use around the world today.

Interestingly, only 52% of respondents said that they routinely asked for valuations to be carried out using a consistent standard and reporting format. Of this group, 60% said they routinely used the Red Book (incorporating International Valuation Standards). Others used domestic codes such as USPAP, or the German Valuation Ordinance & Federal Building Code. Four respondents said they used a mix of USPAP for their US assets and Red Book/IVS for assets outside the US.

6.4 Inconsistency not limited to data

It seems that the issue of inconsistency is not isolated to data. One respondent noted that definitions of property types and uses varied between countries too: *"sometimes the definition of an 'office' is very different between countries".* Effective risk management requires an in-depth understanding of local terminology and definitions, as well as an ability to calibrate different data standards to compare investments on a like-for-like basis.

6.5 Not a problem for every investor

Despite a majority of investors reporting data inconsistency as a problem for risk management, there were others that highlighted the investment potential of opaque markets. These investors noted that a lack of, or inconsistent data might change the risk profile of an investment, but it could also spell an opportunity for greater returns. These opportunities are particularly relevant to investors that can dedicate time to source and interpret available data.

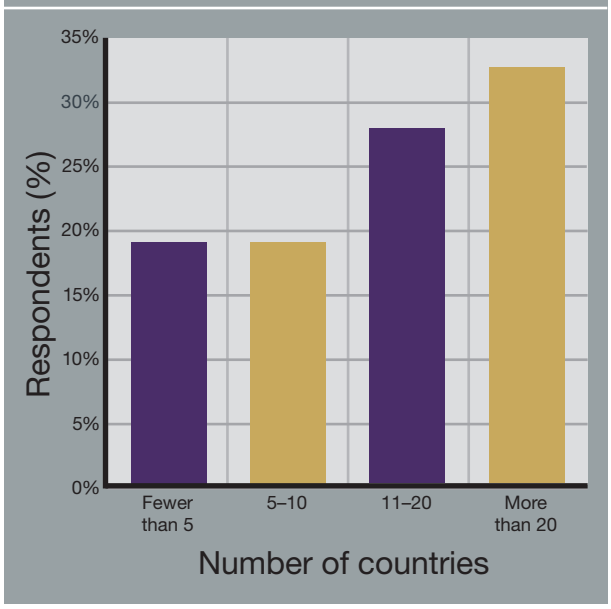
> *Data consistency is a big issue. Where they do exist, data indices will often differ so that it's extremely hard to make like-for-like comparisons.*
>
> **IRF member (Singapore)**

> *With a lack of globally consistent valuation methodologies, and a lack of global indices with consistently captured data, it is not possible to run meaningful risk variance analysis in real estate.*
>
> **IRF member (London)**

7.0 Theme 3: The shifting investment landscape

Over 33% of survey respondents work for organisations **investing in real estate in more than 20 countries around the world.** A further **29%** invest in **between 11 and 20 countries.**

How many countries do you invest in (in real estate) as a business?



7.1 This is a time of change for investors

All respondents are seeing a shift in their investment universe. This tends to be seen in two areas:

1 A changing geographic focus

2 A move into alternative assets

These trends have come about for many reasons, including a changing risk appetite among their investors and a willingness to seek higher returns in non-traditional assets.

The survey found that a third of respondents were investing in more than 20 countries. This statistic prompted questions from the Forum about whether the investment universe had grown or shrunk geographically since the GFC. All acknowledged that capital flows are increasing, with the origins of capital also growing.

This is largely happening in Asian markets where some domestic investors are expanding internationally for the first time. One respondent summed up this shift: *"The global chase for yields is still strong. Japanese and Korean capital has become more active in the US over the last 6 months."* There are also certain markets, including Australia, which were previously less open to the rest of the world. In the last couple of years, global capital has begun to flow in – domestic markets are becoming global.

However, there were two camps regarding the number of markets being invested in: some had grown the number, some had reduced it.

1. **Decreased since the GFC:** for some it links to a decreased risk appetite or bad experiences in a market. But primarily market illiquidity was the reason provided. These concerns are not just on a global level: *"The liquidity question becomes one on not just a global, but national, level. Investors are concerned about where people want to be in the future, so they're more focused on whether they're buying the right asset and whether it's adaptable."*
2. **Increased since the GFC:** with the international growth in real estate, the number of participants entering the global market is increasing. Compressed yields in key markets are driving some of the more entrepreneurial investors into tertiary markets in search of returns.

7.2 Investors are moving into alternative assets

A stronger trend among the respondents was the move into alternative assets.

The general investment environment is one of compressed yields and uncertainty. There are well-documented changes in the retail sector, a heated residential market, and a volatile office market. Respondents are therefore looking elsewhere for value.

Beyond returns, property use classes are also changing, and with it the definitions of what is 'core'. For instance, one interviewee noted that: *"Student housing used to be in the alternatives camp a few years ago, but is now being recast as traditional. The definition of alternative is changing."* Defining what asset types are 'alternative' can also differ by market – much like the respondents noted with asset definitions causing problems in data inconsistency.

Investment managers are seeing stronger demand from their investors to move into these alternative assets.

A 2017 McKinsey report also reflected this *"momentum toward non-traditional asset classes, such as student housing, data centers, healthcare offices, medical facilities, and assisted-living communities."* Global investment in student housing, for example, has more than doubled from $3bn in 2007 to around $7bn in 2015. As the volume and size of these deals increase, McKinsey note that *"they become more attractive to institutional investors looking for scale."*

The move to alternatives is changing the risk profile of investments. Assets such as hotels, student accommodation, healthcare, and the Private Rented Sector (PRS), behave very differently to traditionally core assets such as offices. They operate under different business models with different types of tenants.

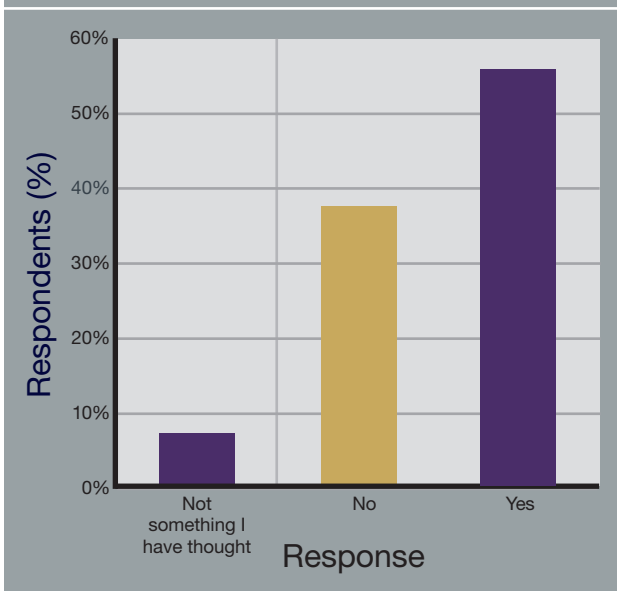
However, when understood correctly, these assets create new opportunities for investors. This is particularly true when taking advantage of new business models. An example given by attendees is the hotel sector. Daily pricing, facilitated by online booking systems, helps to significantly improve occupancy rates. The process is simple – prices can be increased when there's high demand, and reduced when there's low demand. When investors understand the power of these models, they can significantly shift the risk profile of an asset.

To understand these assets – from appropriately managing their risks to achieving the best value from them – many investment managers are developing their in-house expertise to manage style drift into alternatives. Style drift occurs when a fund diverges from its stated investment style or objective. This push is also coming from investors who are calling for more exposure to alternative sectors, but in general want this from specialist managers: *"we created a new alternative assets team this year, because we need experienced people to help us move into the area and reduce the risk of doing so. Some of the skillset is transferable, but ultimately very specific experience is required."*

Compressed yields in other parts of the market appear to be accelerating the move to alternatives. And the competitive environment means it can't be ignored that some investors will likely take higher risks by moving into alternatives without first establishing in-house expertise.

Over half (57%)
of respondents are currently
worried about
style drift away from their disclosed investment strategy.

At this point in the market cycle, do you worry about style drift away from disclosed investment strategy with any of your funds?



> *Alternative sectors are here to stay, and will become a bigger part of the investment universe.*
>
> **IRF member (New York)**

8.0 Theme 4: Emerging risks in 2017

8.1 Changing occupier habits present the biggest risk today

The survey asked investors to score the impact of certain risks, based on the current market conditions and sentiment. Respondents were asked to score the risk on a scale of 1-10, where 1 = little or no impact on investment risk outlook today; and 10 = major risk to investment outlook today.

The risks for consideration were drawn from wide-ranging discussions within the IRF since 2015, along with an option for respondents to add others. Respondents identified the following risks as having the greatest potential to impact investments today.

Risks for consideration	Median score on 1-10 scale
Changing real estate occupation and use habits; Unrealistic valuations; New generations of employees lacking experience of property cycles/ lessons learnt	7
Market adjustments to a new political landscape in the US and Europe; Emergence of new technologies such as Artificial Intelligence; online leasing platforms; Geo political threats	6
New regulatory requirements; Interest Rates; Bond yields; Forex movements	5
Under-investment in city infrastructure; Investor expectations driving a change in strategy; Liquidity; New emerging asset types; Capital flows between developed and emerging economies	4

8.2 Changing occupier habits

Thirteen out of the 21 respondents scored changing occupier habits as 7 or more on the scale.

IRF attendees have highlighted a trend towards greater flexibility in the way properties are designed, managed and leased by, occupiers. Co-working, flexible space is becoming more prevalent in the office sector, building on models like Airbnb and WeWork. As a result, leases are becoming shorter and more flexible, with covenant strength being tested in new ways. For investors, the opportunity to acquire assets with long-term tenants in place is becoming less prevalent.

Although the issue of shortening lease length was referenced by most respondents, one contributor also highlighted that, where long leases are in place, they are increasingly complex with multiple optionalities. The same respondent questioned whether the industry as a whole was doing enough to manage the risks associated with these new long-income products.

Corporate occupiers are also seen increasingly to be taking properties outside central business districts where older building stock is often less versatile. This is even the case in many tier 1 cities. According to one respondent, this migration is less about affordability and more about the ability to lease space which offers greater flexibility, better local amenities and leisure facilities for employees. This is having an impact on the risk profile of some older, built-up central business districts.

There is also a general sense amongst investors that changes in real estate use habits are evolving at a faster pace today than ever before. In large part this is due to the speed at which new technologies are being developed and adopted by businesses. Occupiers are rapidly changing their business models, from the roles they employ to the way they use real estate as a platform for interacting with clients and the consumers of their goods.

Although this trend is not new, several investors noted that the reality of concepts such as driverless vehicles and their impact on inner city parking facilities; drones and their impact on logistics and supply chains; and Artificial Intelligence and its impact on back office functions, are beginning to have a bearing on risk analysis for medium to longer-term real estate investments. Agility and flexibility in the way investments are managed is increasingly seen as important mitigation at this time of change.

Longer-term demographic trends are also leading to adjustments in risk outlook for certain assets. A good example of this is the impact of aging populations in much of the developed world on the investment attractiveness of senior living accommodation.

> *Occupiers are seeking modern, flexible offices and leaving older properties in central business districts to achieve this. In the US as many as 80% of buildings are more than 10 years old.*
>
> **IRF member (New York)**

> *Driverless cars will be a reality in the not too distant future. Investors with multi-storey car parks in their portfolios are now thinking about the risks and opportunities.*
>
> **IRF member (London)**

> *The growth in online consumerism is changing the way traditional retail space is viewed. People are happy to pay a premium if they can take delivery of goods at home or work on the same day.*
>
> **IRF member (London)**

> *In a private market like ours Red Book valuations are the best attempt at estimating value.*
>
> **IRF member (London)**

> *Valuations can be high. Assumption drift is the challenge.*
>
> **IRF member (London)**

8.3 Institutional learning and knowledge sharing between cycles

Ten of the 21 respondents said the risk of not sharing institutional knowledge of previous cycles with new generations, was 7 or more on the scale.

IRF participants have highlighted the risk that new generations of staff are often not routinely trained to understand the characteristics, decisions and lessons learnt from previous cycles. Several noted that institutional knowledge and experience is often not formally documented or shared only anecdotally, with one investor highlighting this as the "number one risk" for their business today.

One respondent noted that as many as 60% of current employees in their business have joined since the 2007/08 financial crisis. Educating and training new staff was acknowledged as essential to ensuring a risk-based approach to investment. Some investors highlighted ways by which they support the sharing of knowledge between generations of staff and investment cycles. This included things like:

- Encouraging junior staff to join or listen in on investment committees;
- Carrying out back-testing of investment decisions to review performance in changed markets and between cycles;
- Establishing a formal process for documenting, reviewing and sharing lessons learnt.

8.4 Valuation accuracy

The risk of valuation inaccuracy is not new, nor is there any suggestion it is changing in prevalence or nature. However, it has been marked highly among respondents given its importance to the investment process.

For the majority of investors asked, valuations were considered a key component of risk management, providing the best objective and benchmarked means of comparing assets at a given point in time. Most investors said they carried out more than one valuation of an asset and portfolio each year, with some carrying out valuations as regularly as monthly.

Ensuring valuation quality and consistency is important for investors. To achieve this, more than half the respondents said they required the use of common valuation standards (e.g. the RICS Red Book), applied by qualified and independent professional valuers. This was seen to be the best means of limiting valuation variance within and between markets.

Despite applying measures to mitigate valuation inaccuracy, respondents highlighted two dynamics which can make valuations inherently challenging:

1. There was a sentiment that valuers can sometimes be slow when marking up in a rising market and down in a falling market. Some respondents noted that this delay reflected the low speed and frequency of transactions, with the result that valuations could lag market turns.
2. Some respondents highlighted the challenge of obtaining valuations in distressed, illiquid markets where comparables can be sparse due to limited transactions. This can be particularly challenging for investors looking for exits during times of volatility.

> *There is real value in sharing the insights of generations that have lived and worked through various market cycles. This is something we need to think about improving across the industry to ensure we don't make the same mistakes.*
>
> **IRF member (New York)**

Part 3: Leading by example

9.0 Chair's conclusion

Real estate underpins the global economy. According to a 2016 Savills report[3], the total value of real estate is around US$217 trillion. In 2016 alone real estate transactions were estimated at US$4 trillion, or 3% of global GDP. But real estate's impact on financial stability goes far beyond its direct contribution to global output; it is the primary store of wealth and security for families; a centre for business, manufacturing and trade, and a huge source of employment worldwide.

As with any asset class, real estate investors' primary objective is to generate satisfactory risk-adjusted returns. Equally, the decisions we make as investors in this complex, multilayered and global industry have significant implications for society as whole. We bear a heavy fiduciary duty in supporting responsible and sustainable markets.

We cannot discharge this responsibility without a sophisticated and professional approach to risk management. There will always be unforeseen events that no-one expects. But to call something a "black swan" as an excuse for poor risk management is unacceptable.

This should only encourage us to work harder to mitigate and avoid the risks we can foresee. We must ensure our real estate portfolios, built from other people's money, are resilient to the proverbial "unknown unknowns". We must do more to document and share lessons of the past with new generations. We must work more collaboratively outside traditional professional silos to spread best practice, while calling out irresponsible behaviours.

Together, members of the Forum have highlighted several areas for improvement that should act as a catalyst for wider industry collaboration:

1. Availability of, and access to comparable benchmarking data: greater accessibility to indices that can enhance benchmarking and the ability to manage risk prudently. Data sets such as total returns are available in some developed markets but there is a need to capture this information more systematically around the world.
2. Consistent bases for property market data: common standards that underpin real estate information would ensure property data is more transparent, comparable and meaningful across markets, to allow better informed decisions on investment risk. Some international standards exist today, including international standards for valuation (IVS) and property measurement (IPMS), but more can be done to encourage the use of these standards and ultimately create greater market confidence.
3. Thought leadership and sharing of best practice: the industry needs to share innovative thinking, market insight and best practice. As a priority, we need to share lessons with new generations of employees, in particular on liquidity management; integration of research in the risk management process, and practical approaches to risk management.

The RICS Real Estate Investment Risk Forum embodies genuine leadership at the top of our industry, with a collective desire to advance risk management for the greater good. Our sector has made great progress over the past ten years and there is still a lot more that can be done.

3 Around the world in dollars and cents (January 2016)

Confidence through professional standards

RICS promotes and enforces the highest professional qualifications and standards in the development and management of land, real estate, construction and infrastructure. Our name promises the consistent delivery of standards – bringing confidence to the markets we serve.

We accredit 125,000 professionals and any individual or firm registered with RICS is subject to our quality assurance. Their expertise covers property, asset valuation and real estate management; the costing and leadership of construction projects; the development of infrastructure; and the management of natural resources, such as mining, farms and woodland. From environmental assessments and building controls to negotiating land rights in an emerging economy; if our professionals are involved the same standards and ethics apply.

We believe that standards underpin effective markets. With up to seventy per cent of the world's wealth bound up in land and real estate, our sector is vital to economic development, helping to support stable, sustainable investment and growth around the globe.

With offices covering the major political and financial centres of the world, our market presence means we are ideally placed to influence policy and embed professional standards. We work at a cross-governmental level, delivering international standards that will support a safe and vibrant marketplace in land, real estate, construction and infrastructure, for the benefit of all.

We are proud of our reputation and we guard it fiercely, so clients who work with an RICS professional can have confidence in the quality and ethics of the services they receive.

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