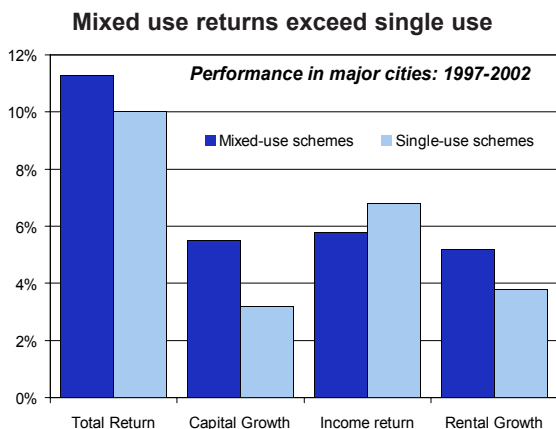


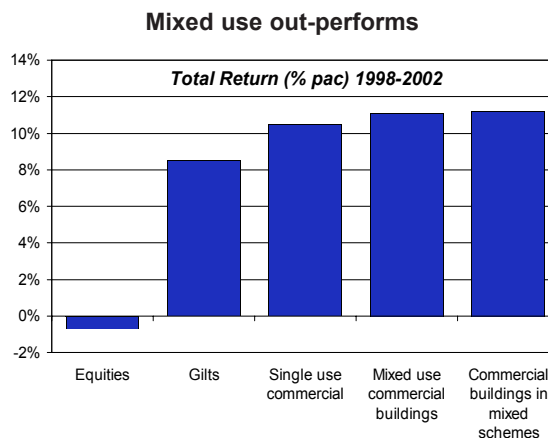
Investment in Mixed Use

Summer 2003

The impact on commercial property investment returns of mixing uses



Source: IPD, FPD Savills Research



Source: IPD, FPD Savills Research

Summary

- This report contains the results of the first study of its kind to determine the impacts on investment performance of mixing property uses.
- Buildings on mixed use developments have shown significantly better total investment returns in recent years than properties in conventional built environments in the same location and total investment returns on mixed use properties are superior to single use properties.
- Only a small proportion of existing, standing investments are in mixed use buildings. Most of these buildings are a combination of offices and retail space.
- The study sample represents the results of past investment decisions by fund managers, it is not necessarily indicative of current new investment in mixed use or of what might happen in future.
- Mixed use buildings and buildings in mixed use schemes have shown superior rental growth compared to single use buildings. Occupiers may prefer mixed use environments.
- A lack of information may have kept investors away from the mixed use sector in the past, although there are signs that it has begun to find favour in very recent years.
- Mixed use is not analysed and benchmarked as a separate use class. Fund managers therefore find it difficult to change the mix and weighting of their portfolios when they are invested in mixed use schemes and buildings. This is a major barrier but specialist property investment vehicles could help.

Changing planning & development

The nature of planning and development has changed over the last few years. The urban agenda and the need to regenerate inner cities and redevelop previously-used land has resulted in a series of planning and policy initiatives. One of the results of this movement has been an increased incidence of mixed use development, often on large sites. Whether driven by necessity or planning imperatives, or a combination of both, many new, urban development sites are markedly different from the single use sites that have been seen in the past. This gives rise to different types of buildings and different types of environments from those seen before.

Many of the new environments, for example the restored areas of Covent Garden and Butler's Wharf in London, the Liverpool Docks, Bristol Harbourside, Glasgow's Merchant City or the newly-built environments of Brindley Place in Birmingham, Cardiff bay or Southampton's Ocean Village, have been widely acknowledged as being commercially, socially, aesthetically and environmentally successful. However, no-one has hitherto studied whether these places are successful from the point of view of a property investor.

The investment impact of mixing property uses may be under researched and improperly understood but investor sentiment and demand for buildings has an important impact on the value of buildings. It is therefore an important, key element that will determine whether future development takes place.

In the absence of empirical evidence, the investment world has been uncertain as to how to assess and value buildings with more than one type of use in them and buildings within new, mixed use schemes. This has a profound impact on the capital value of a development (its gross development value or GDV). Perceived risk or expectations of lower returns will instantly devalue a development and make it more difficult for a developer to compete on land price with single use schemes. Important questions arise regarding the nature of the mixed use phenomenon. What price should investors pay for buildings that have many different uses in them? Is the building going to perform better or worse than buildings with only one use? Investors are now beginning to look at these questions but they haven't been fully answered in the past and still remain to be fully addressed.

An understanding of mixed use performance is important in determining the value of a scheme and also whether there will be investment buyers for it. The absence of information creates investment uncertainty and adds to the perceived risk of investing. Some investors will be put off entirely by this, thereby lowering demand for mixed use products, and others will pay less for a building than they otherwise would if the sector were well understood and monitored. This is an important and ground-breaking survey which looks at investment returns on mixed use buildings in order to answer some of the questions of mixed use investment performance.

The research

In order to examine some fundamentals of mixed use property investment, we looked at both mixed use buildings and buildings in mixed use schemes in two separate studies. First, we compared the performance of buildings on mixed use sites with buildings on single-use sites. Second, we compared the investment performance of mixed use buildings with standard, single-use buildings in the same locations. In each case, we looked at the investment performance in terms of income return, income growth, capital growth and total returns. The investment performance data was obtained from IPD and covers all major property holding by UK property investing institutions.

The first study looked at the performance of individual buildings within major, specified mixed development schemes in major towns and cities throughout the UK. These were selected on the basis that they were significant developments of clearly mixed use across as broad a geographical area as possible. Thirty five such schemes were identified in all. The performance of buildings within each of these schemes was then compared with the same types of property in the same locations outside of the scheme. The second study looked at all mixed use buildings in the IPD database. A mixed use building was deemed to be one where more than 10% of its income stream was derived from an additional property use or uses. To counteract possible locational and other biases in this sample, we selected for comparison only single use buildings which were of an equivalent status and location to the mixed use buildings.

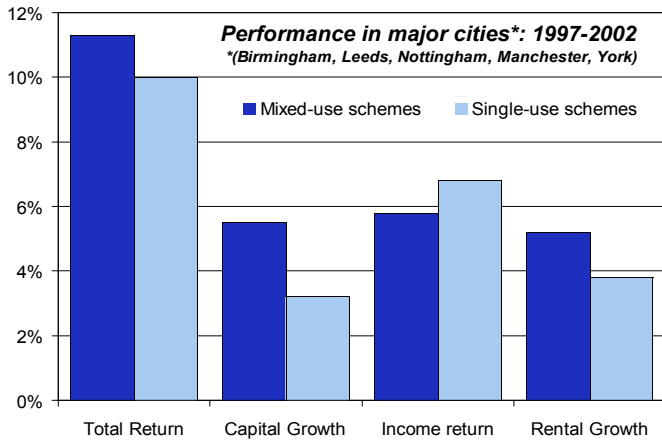
It should be noted that the sample consists only of standing property investments owned by funds. It therefore represents the results of past investment decisions by fund managers, it is not necessarily indicative of current new investment or of what might happen in future. It is also interesting to note that there was not a particularly large number of multi-use buildings in the sample. Of the 6,823 properties in the IPD database of property investment funds, only 548 have a significant mixture of two or more uses. This is just 8% of the total sample.

The mixed use development schemes are, by their nature, a biased sample. All are recently built (because large-scale, mixed development is a relatively recent phenomenon) and they are concentrated in metropolitan centres. These factors, in themselves, could be reasons for out-performance or under-performance. The small appetite for mixed use property amongst established investment funds was also indicated by the fact that, of the 35 mixed use developments selected, only 6 of the schemes had a sufficient number of institutional investors in them to enable a study to be made without breaching the confidentiality of any one fund. This lack of investor appetite, in itself, has an important impact on the mixed use sector. Lower demand will usually mean lower capital values and a perception amongst investors that the sector is more risky because fewer of their peers are participating in it. This, in itself, could create further price differentials.

Mixed Use schemes outperform

The first study looked at finished development schemes that have a mixture of different property uses in them. Some of these schemes contain residential as well as office, hotel, leisure and retail property. Due to the nature of the IPD database, which reflects the fact that residential property is not widely invested in by the funds contributing to IPD, the returns on these schemes only cover commercial uses. An idea as to how the residential element might perform has been given separately (see opposite).

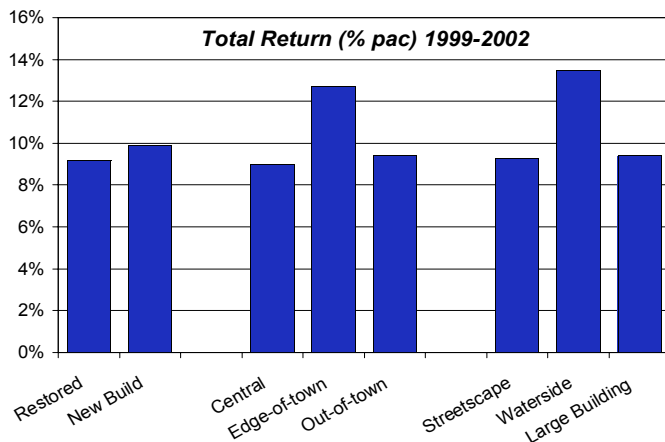
Investment returns for developments



Source: IPD, FPD Savills

Total returns for property in the selected, mixed-use schemes were found to be significantly higher than those for comparable property in the same location. This may have to do with the relative attractiveness of the properties in mixed use schemes and the superior quality of the large, new developments that were selected for this study. The ongoing rental growth of these schemes has also been high compared to buildings in surrounding single use developments. It would appear that investors have found favour with the schemes and capital values have risen on the back of superior rental growth and falling equivalent yields.

New build, town edge, waterside works best



Source: IPD, FPD Savills Research

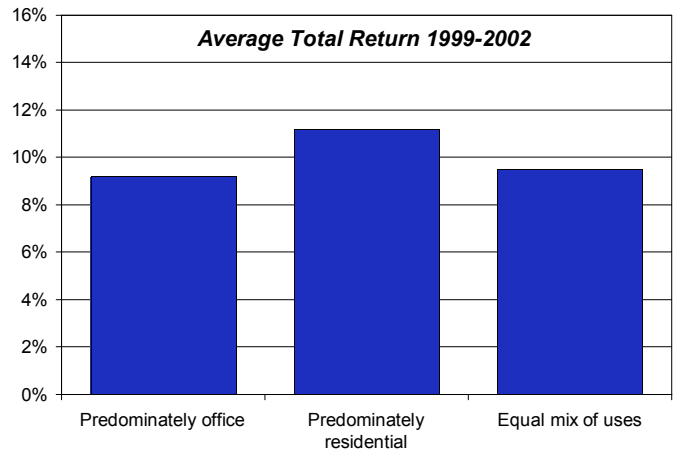
The development implications

Investment returns were found to be superior on new build schemes, (as opposed to ones where old buildings had been restored). Returns were also enhanced on edge-of-town, rather than town centre or out-of-town sites. The presence of water has long been acknowledged as something that adds value to residential units but it also appears to make a big difference to the size of returns on commercial property.

The role of residential use

An increasing number of mixed use schemes are now led by or include residential property. We have therefore looked at the performance of all commercial property (shown below) when a development scheme is predominantly residential. It would appear that the investment performance is enhanced by the presence of residential uses over and above schemes which are predominantly commercial in their mix. This, in itself, may be a sound rationale for mixing commercial and residential uses, provided buyers/investors can be found for the residential elements.

Residential appears to enhance performance



Source: IPD, FPD Savills Research

This research does not measure the impact of mixed use on residential returns. This is because large, institutional property investors have not invested in this type of property in the past and so there are insufficient numbers of residential units in the conventional IPD sample. The small IPD sample of residential portfolios is also incapable of being analysed for this survey because very few of the properties in it are in mixed use development schemes. Nevertheless, we have offered here some clues as to how residential property impacts commercial property investment performance favourably. During 2002, residential returns, recorded by IPD were 17.7% comprising 5.4% income return and 12.3% capital growth. In view of the fact that residential property has outperformed commercial property investments in recent years, we expect to see a gradual increase in residential property holdings amongst institutional investors over the medium to long term.

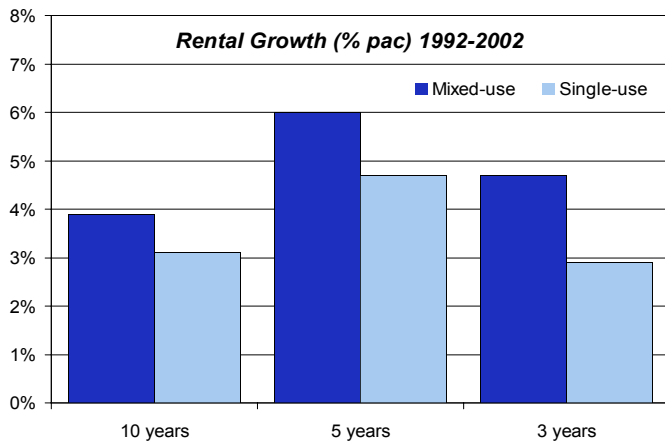
Investment in mixed use buildings

The second part of the survey looks at the performance of stand-alone buildings that have a mixture of different uses in them. These buildings were found to perform differently to those with only a single use in them.

The graphs below show that rental growth for multi-use properties across the UK has been better than that on single-use properties. This may be because rents are set too low by the property industry at the start of a tenancy or it may be due to excess demand over single use properties. Whatever the case, this pattern has been consistent over the short, medium and longer term. Rental growth has averaged at least 1.4% per annum compound more for multi use buildings than mono use buildings over the last 10 years. The rate of excess growth has accelerated in the last 3 years.

These are significant findings when it comes to investor fundamentals. Rental growth can be an important indicator of underlying occupier demand. It could indicate that the businesses that occupy multi use buildings are more likely to want to pay more to move in or stay there than businesses in single use buildings. This is despite the popular belief in the property industry that occupiers (especially office occupiers) want their own dedicated building. It may be that users are being tempted into multi use buildings at lower rents but rent reviews are gradually bringing their rents more in line with single use buildings as occupiers become established.

Rents in mixed use buildings have grown faster

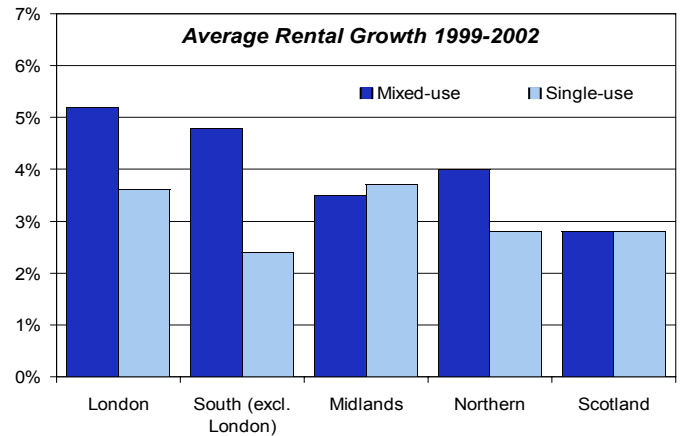


Source: IPD, FPDSavills

This phenomenon of higher rental growth is not confined to any particular location although mixed use in some places has outperformed by much more than in others. Over the last three years, London's multi use properties in standing, institutional investment portfolios have seen average annual growth of 5.2% against 3.6% growth in single use buildings. In the South, the difference is even more pronounced at 4.8% and 2.4% respectively. Only in the Midlands, do single use buildings show higher rental growth.

Regional variations

Rental growth superior in most regions

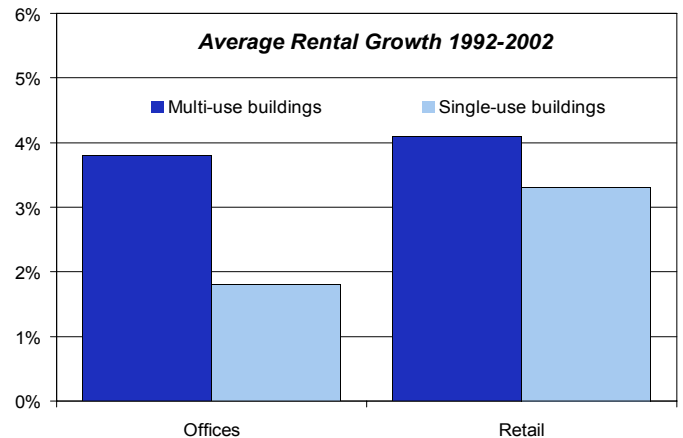


Source: IPD, FPDSavills

Sector variations

Perhaps surprisingly, it is offices that appear to benefit most from having other uses in the same building. The graph below shows the rental growth of the buildings which are mixed use but predominantly offices against those that are predominantly retail. Both are compared against their single use counterparts. It is easy to see why retail tenants might prefer to be in an office building where there is self-generated footfall and therefore increased custom over and above what might be expected in a single-use building. It is noteworthy that office occupiers might also consider an adjoining alternative use to be attractive. Once again, we face the possibility that the property industry might be over-discounting office rents in mixed use buildings at the outset of a tenancy. Office rents may therefore be rising exceptionally fast as the landlord and tenant play catch-up over the course of the lease. Maybe both owners and occupiers need to re-examine preconceived attitudes to mixed use environments and the rents they pay for them, especially in the case of offices.

Office use benefits most from mix



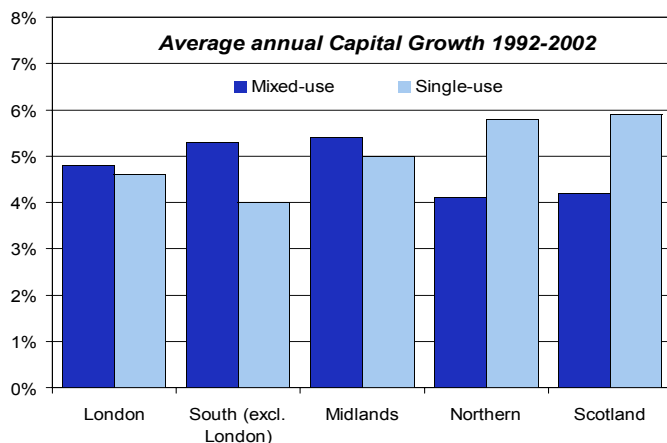
Source: IPD, FPDSavills

Investor demand makes a difference

It is possible that the excess rental growth of mixed use buildings results from the low pricing of initial rents but it would be surprising for this to be widespread or persist for long in the face of comparable evidence from other buildings. Set against the very clear superiority of mixed use rental growth in London and the South is a yet larger, but not as pronouncedly larger, difference in capital growth. Whilst mixed use rental growth out-performs by between 1.6 and 2.4 percentage points, capital growth out-performs by just 0.2 and 1.3 percentage points respectively.

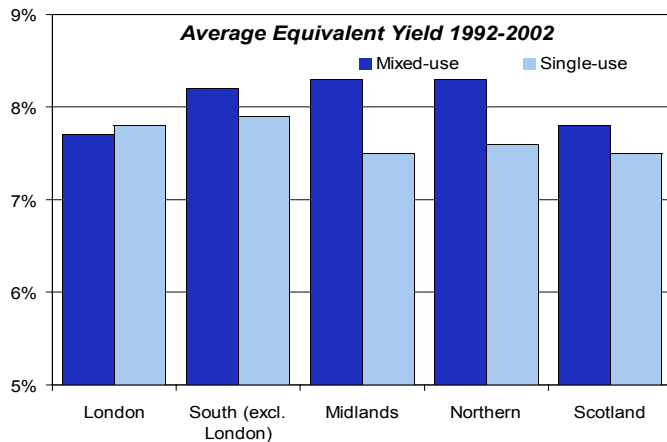
In the North, the situation is even more perverse. Whilst mixed-use rental growth out-performs by a significant margin, capital growth under-performs even more significantly. This can be put down to investor attitudes. Investors in the regions with lower capital growth have been buying mixed use properties off much higher yields than the yields they have been applying for single use properties. This prevails everywhere except in London and underlies the inferior capital growth seen in Scotland & the North.

Capital growth marginally superior for multi use ...



Source: IPD, FPD Savills

... due to higher yields

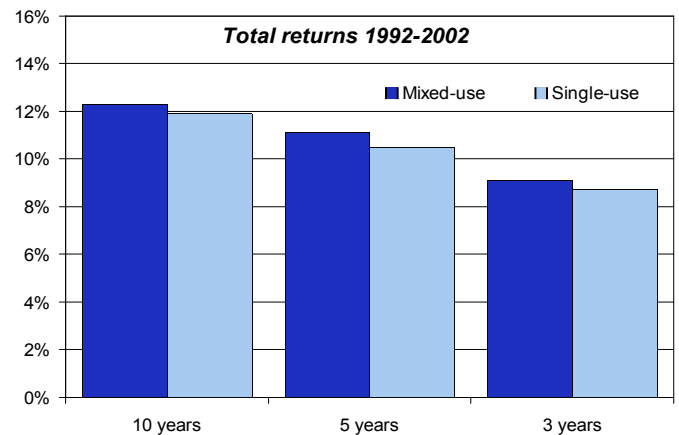


Source: IPD, FPD Savills

Income and total returns

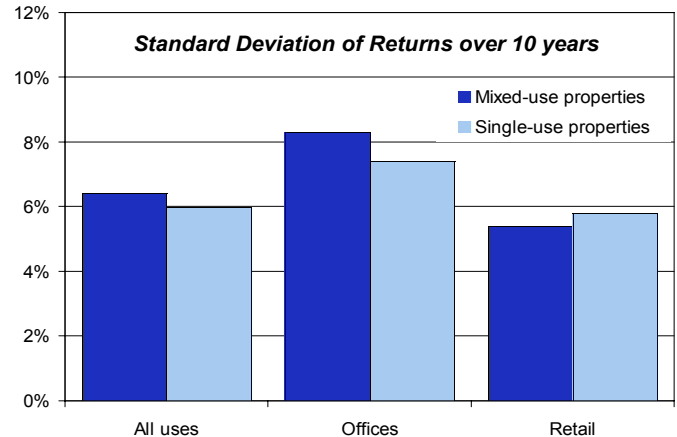
Ongoing income returns inside standing investments have been roughly the same for mixed use properties as for single use properties. Total returns on the other hand have been, consistently, marginally superior over the last 10 years. It would appear that these enhanced returns come at the price of higher risk. The volatility of returns on mixed use buildings is higher than on single use properties. This goes some way to explaining why investors are buying off higher yields and expecting higher income returns.

Enhanced returns ...



Source: IPD, FPD Savills

... at higher risk?



Source: IPD, FPD Savills Research

It appears to us that the out-performance of mixed use development buildings is due to two factors. One is the lower capital value of multi use buildings (and mixed use schemes) which are being bought at higher yields than single use buildings and schemes. It is also down to fundamental factors of tenant demand. It might appear that where a mixture of uses are combined to create an attractive business and/or residential neighbourhood, the value of the place to occupiers increases.

The case for mixed use investment

Barriers

From the results of the survey, there appears to be few reasons why investors should eschew mixed-use properties or why they should be seeking higher yields on them. But, even where an investment case is attractive, there are still concerns amongst certain investors regarding resale potential and “exit routes” for mixed use schemes. These include, for example, possible difficulties in redeveloping a multi-occupied and multi use site when some uses are nearing obsolescence. Redevelopment of buildings may be difficult if parts are securely occupied for longer periods of time than others. This especially arises in cases where residential (on 99 yr leases) is mixed with, say, office uses (on 25 year leases). The lack of investor appetite for mixed use buildings may, by itself, cause an increased perception of riskiness amongst investors. Any discrepancy in values that result from investor attitudes towards mixed use versus single use will impact on the viability of a scheme. A single percentage point difference in the yield that an investor expects from a building can have a major impact on site value.

Average equivalent yields for mixed use buildings in the survey were higher than for single use buildings, although not by much. The nature of standing institutional investments prevents us saying much on the subject of initial investment yields in the “real” world as the equivalent yields in a sample of existing investment buildings will be those derived from valuations rather than from actual transactions. Valuation data is likely to be smoother and less likely to reveal any anomalies in purchasing behaviour compared to data taken from actual purchases of both single use and mixed use buildings.

The use by investing institutions of modern portfolio theory and the analysis of property investment performance by sector is another barrier to investment in mixed use. Mixed use is not, traditionally, analysed as a separate use class so mixed buildings do not fit easily into existing models. They cannot be partially traded to increase the weighting of one use and decrease another within a portfolio. We see that there may be a case for tax transparent property vehicles to provide a virtual means for portfolio managers to balance and weight their portfolios by sector, even when the stock itself is in mixed buildings.

Savills plc

Savills plc is a leading international property services company with a full listing on the London Stock Exchange. The company has undergone dynamic growth in recent years establishing itself as a powerful player on the international stage with offices and associates throughout the UK, Europe, Asia Pacific and Africa. In addition, Savills strategic alliance with a top US full service real estate advisory company, Trammell Crow Company, means that clients have access to a network of offices in the US and Canada. FPD Savills is the trading name for the property service subsidiaries of Savills plc which advise on commercial, rural, residential and leisure property. Other services include corporate finance advice, property and venture capital funding and a range of property related financial services.

Opportunities

Despite the barriers, our prognosis for the future of investment returns from multi-use buildings is rosy. We foresee that the enhanced rates of return will continue over the short to medium term. Even if, in the medium to long term, yields adjust downwards in line with single use, we foresee that buildings in good mixed use schemes will do better than those in mono-use developments as occupier demand will be greater for them. There are two possible investment opportunities that arise out of this. The first is to buy mixed use and multi use cheaply, off relatively high yields and take advantage of other investors lack of appetite. If past performance is indicative of what will happen in future, not only will total returns be higher than single use properties but rental growth should out-perform as well. If investment yields remain stable, this, in itself, will lead to capital growth. The other play is for investors to anticipate an improvement in the appetite of other investors for mixed and multi use property. Increasing knowledge of the returns available and a proven track record in existing buildings should gradually bring yields more in line with single-use commercial properties. This, in and of itself, should lead to capital growth, even in the event of no rental growth.

Conclusion

This research shows that the case for mixed use investment is robust but there are barriers to a wider take-up of mixed use buildings by investors largely because of difficulties in applying modern portfolio theory to mixed buildings.

Investors may still be left with the question of whether marginally enhanced returns justify the extra perceived effort of making mixed use work. We anticipate that any breakthrough in the proliferation of new mixed use schemes and buildings is unlikely to be led by investor demand and more likely to occur through policy pressures, planning and the nature of new development sites.

Occupier demand for mixed use may also become a more potent force in the success of multiple use sites. What investors can take away from this research is the reassurance that participation in such property is unlikely to lead to reduced returns and could result in better performance.

Mixed Use Research

Yolande Barnes
Director
+44 (0) 20 7409 8899
ybarnes@fpdsavills.co.uk

FPDSavills Head Office

20 Grosvenor Hill
London W1K 3HQ

Switchboard

+44 (0) 20 7499 8644

Fax

+44 (0) 20 7753 8919

www.fpdsavills.co.uk