

UK real estate insights

Issue 6 – November 2007

Contents

- 2 Introduction
- 4 Real estate finance and the credit crunch
- 6 Proposals for changes to the VAT option to tax regime
- 9 What does the future hold for UK property fund vehicles?
- 11 HMRC proposals may affect offshore real estate funds
- 13 Developments in the hotel sector
- 14 Saving the planet – can tax and regulation help?
- 16 European Real Estate conference

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Introduction

Welcome to the latest issue of *UK real estate insights*. It has certainly been an eventful three months since the last issue, in which we concluded that real estate equity and debt markets were heading for a period of volatility, with yields softening, lenders becoming wary and open-ended funds facing significant redemptions. However, we did not realise how rapidly things would move, and we did not predict that a major liquidity crisis and the first run on a UK bank in one hundred years would occur within the month.

Although the press coverage of the credit crunch has been focused on the negative aspects, many of our clients see this as beneficial for the UK real estate market. The UK market had already peaked before August. A liquidity event that turns a gradual downward drift into a much more rapid readjustment should bring us to the bottom of the cycle more quickly. All the evidence at the moment is that the real estate fundamentals are still sound and that what we are seeing at the moment for both real estate debt and equity is a correction to the pricing of risk. It is also significant that the economy seems to be in reasonable health. A key uncertainty facing the UK economy at present is how far the effects of the recent credit crunch will spill over from banks and other financial institutions to the rest of the economy. According to the latest PricewaterhouseCoopers (PwC) economic survey, the UK corporate sector as a whole is in much better financial health now than it was five years ago. Profitability is significantly higher, gearing is markedly lower, and interest cover ratios have risen. Most parts of the UK corporate sector appear to be in reasonably good financial health: if a storm is coming, they are generally well

placed to weather it. There are, however, some sectors where comparatively weak finances and relatively cyclical markets could nonetheless make them vulnerable to a sharper than expected downturn, including the computer software, technology, automotive, non-food retailing, construction and media sectors. Some banks and other financial institutions are clearly also relatively exposed to the credit crunch. The economic review also looks at UK house price prospects and the most likely scenario is for a slowdown in the housing market. To read the full economic survey report please [click here](#).

Even within the real estate market, what is a problem for some is an opportunity for others. The re-pricing of risk is helping traditional balance sheet lenders and less heavily geared equity become competitive again in a market where in recent years leverage and yield compression had made it difficult to lose money on property. We are now seeing a flight to quality as equity and debt providers rediscover scepticism. We are just starting the interview process for the *Emerging Trends in Real Estate® Europe* report that we produce with the Urban

Land Institute. This report gathers the views of four hundred leading players in the European real estate market through interviews and surveys. It will be very interesting to see how market sentiment has moved since this time last year. The comments that we are receiving from clients support the view that the shift in the UK market and the impact of the liquidity crisis creates opportunities. This was also the consensus view at the panel on the UK market that I chaired at the recent IMN Real Estate conference, as well as at seminars that we have run at PwC.

The last issue of *UK real estate insights* included an article by Barry Gilbertson on the areas of the real estate market where we are seeing distress, and the opportunities that this might present. Barry is an expert in property insolvency and a leading fixed charge receiver and has also been running a series of workshops for lenders and others regarding the current state of the market. To obtain a copy of the workshop materials, please contact the [UK real estate insights team](#).

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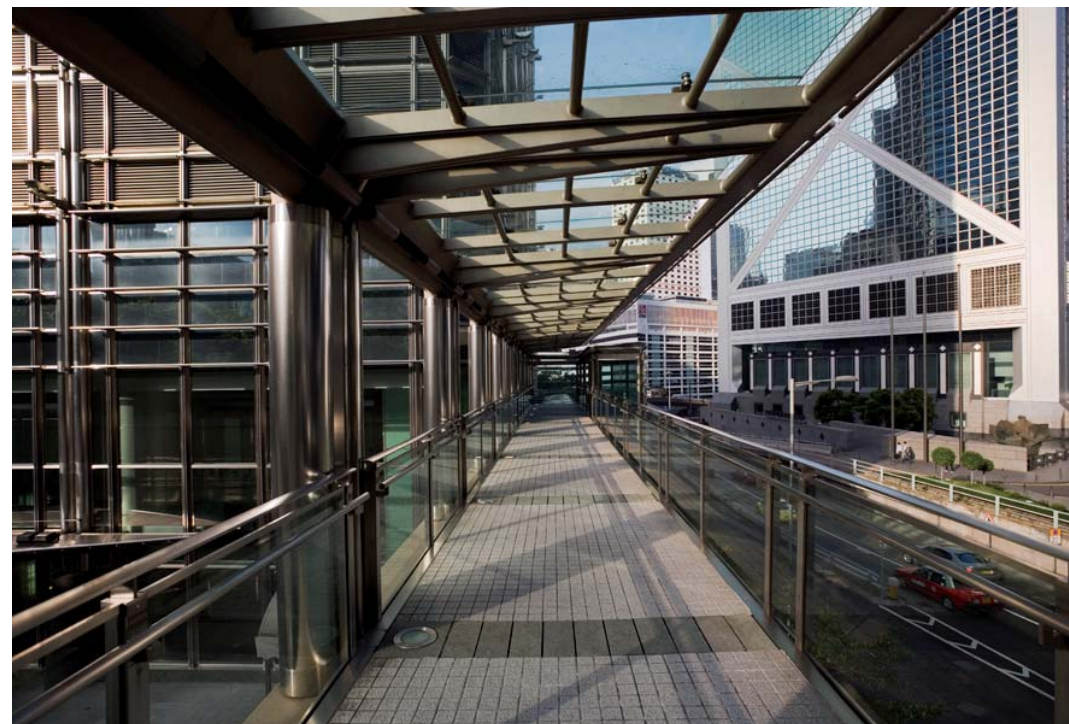
Introduction

In October, we also ran a seminar for property occupiers, covering both commercial and tax matters. Despite the impact of the credit crunch, there was still considerable interest in the same topics that were the focus of attention at the start of the year – in particular Opco/Propco. There was a widely-held sentiment that although the private equity buyers had initially been stopped in their stride by the credit crunch, this is only a temporary reprieve. Again, to obtain a copy of the workshop materials, please contact the [UK real estate insights team](#).

Further evidence of the opportunities presented by current market conditions is the amount of fund raising activity underway at present, both for investment in the UK and elsewhere. The sense that the credit crunch is compressing the downward turn of the real estate cycle is encouraging fund managers to raise cash for opportunities that arise from distressed situations and also to be able to catch the bottom of the trough. In assessing the current market, the UK market cannot be looked at in isolation. For both local players and inbound

investors, the risk adjusted returns of a UK investment need to be compared to the other investment options available. The impact of the current liquidity crisis has not been even across the world. We are seeing increasing interest in emerging markets in Europe, particularly Russia, and looking further, investors are looking at Asia and even Latin America. The current weakness of the dollar is also creating opportunities in the US. In October, together with the Urban Land Institute, we published the Asian and North American issues of the Emerging Trends in Real Estate® reports. If you wish to receive a copy, please email the [UK real estate insights team](#).

The real estate industry is facing a range of short-term and long-term uncertainties that present huge opportunities for the fleet-of-foot that are able to adapt to the new environment, but a major threat for those that are unable or unwilling to change. The broad range of articles in this quarter's issue of UK real estate insights reflect this. I hope that you find it a useful and interesting read. We are always keen to hear your



views on the topics covered and to receive suggestions as to areas that we should cover in the future, either in the publication or through seminars and events, so please share your thoughts with the [UK real estate insights team](#).

Finally, for the many of you attending our European real estate client conference on 16 November, I look forward to seeing you there.

[John Forbes](#)
PricewaterhouseCoopers UK real estate leader

Real estate finance and the credit crunch

In this article, [Paul Davis](#), leader of PwC's Debt Advisory practice and [Jason Green](#), a director in the same team, consider the effects of the current credit crunch on the UK real estate sector.

The current credit crunch did not start with lenders in the US providing mortgages to sub-prime borrowers. For the origins of the crunch, we need to look further back in time, to the turn-of-the-century dot-com crash and the subsequent downturn in the US economy in particular. In reaction to this downturn – and to the later events of 9/11 – central banks around the world, led by the Federal Reserve Bank, cut interest rates significantly. At the same time, a significant increase in global supply capacity, due to the rise of China in particular, helped to keep global inflation low. With the Chinese saving a high proportion of their rapidly growing earnings and the Chinese Government using this money to buy dollar assets (a recent example being the US\$3bn investment in Blackstone's fund), there was a further boost to global liquidity.

What followed was a return to confidence and economic growth from 2003 onwards, encouraged and fuelled by lower interest rates, low inflation and plentiful global liquidity. Over much of the period between then and now, money has been cheap and there has been plenty of it about. This has supported strong growth in asset prices whether of equities, real estate or other asset classes. The development of the US sub-



prime mortgage sector was a reflection of this increase in liquidity and the need for it to be put to work. It is probably the most obvious example of what some have called the 'credit bubble'.

As has been well publicised in the press, these problems in the US sub-prime mortgage sector have caused nervousness in credit markets around the world, particularly in the US and Europe. This nervousness has not been restricted to the mortgage sector and other, seemingly unrelated, credit markets have also suffered.

A factor in this has been the increased use of securitisation and similar techniques which have the effect of spreading risk around the financial system, including beyond national borders. Securitisation can reduce the chances of a bank failure in the event of large scale defaults and proponents point to the role of securitisation in enabling the financial system to withstand significant credit events over the past decade or so (e.g. the Long Term Capital Management hedge fund collapse, 9/11 and SARS).

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Real estate finance and the credit crunch

However, more recently, some commentators have observed securitisation techniques have led to a loss of transparency in the financial system; that is no-one can be quite sure where exposures lie. Banks which might not have been expected to have been active in US sub-prime mortgages – including UK banks – have surprised commentators by declaring significant losses in this market.

This loss of transparency is one of the factors in the sudden loss of liquidity in debt markets over the summer period. Banks have become nervous about lending to each other in the inter-bank market, have withdrawn preliminary finance offers made to corporate borrowers before the crunch and have struggled to syndicate underwriting commitments which they contractually committed to before the crunch began.

The difficulties faced by banks in syndicating their underwriting commitments is probably the biggest problem facing debt markets today. For example, recent estimates have put the value of leveraged loan underwriting commitments at between US\$300-US\$400 billion globally.

These commitments are ‘stuck’ in the banking system and, until they can be successfully syndicated, banks holding the loans will lack the balance sheet capacity necessary to take on new commitments.

Although these problems have affected sentiment and liquidity in large parts of the financial system, the real estate sector faces particular challenges for two reasons:

- Lenders are being particularly cautious about real estate lending, because the US sub-prime market is a mortgage market and therefore, there is a link. Although the link may be viewed as tenuous (i.e. a commercial real estate loan in Europe may in fact have very little in common with a residential sub-prime loan in the US) the current nervousness in the market may mean establishing a link is enough to put off a lender.
- Much of the liquidity driving the growth in real estate transactions in recent years has come from institutional investors, through residential mortgage-backed security (RMBS) or commercial mortgage-backed security (CMBS), collateral loan obligations

(CLOs), structured investment vehicles (SIVs) and other structured product vehicles. Investors rely heavily on ratings ascribed to paper issued by such vehicles to assess the creditworthiness, and therefore attractiveness, of the paper being offered. The fact is, investors have had their faith in the rating agencies shaken by the US sub-prime debacle and this has caused the sudden and large scale withdrawal of liquidity from the market. The CMBS market has been effectively closed for business since the crunch began.

So, is it all bad news, or can real estate transactions still attract finance in the market today? Following the challenges for the sector set out above, here are two reasons to take a much more upbeat tone:

- Real estate is real – the fact remains investors and lenders fundamentally like physical assets which support credit assessments. The events of the summer period have blown some of the froth away from the real estate market (which is no different to the froth also seen in other credit markets and whose partial demise is regarded by many to be no bad thing) but

good quality assets underpinning well structured transactions can still attract finance.

- Many banks are still hungry – although many banks and investors have retrenched, it is by no means all. PwC’s Debt Advisory team has found a number of lenders able to finance at attractive rates; we have continued to be busy through the market turmoil of the last three months. While there is nervousness in the syndication market – banks are loathed to underwrite large deals as they have lost confidence they can sell down the loans to a number of participants – smaller deals (and ‘small’ still means under £500 million) can be placed with a small club of lenders, without the need to heavily rely on the syndication market.

The important issue therefore is to know the market and players – who is hungry, on what terms, can it be syndicated or clubbed, and will banks deliver on promised facilities when they get to their credit committees. Nothing has fundamentally changed in the real estate market in the last few months. It’s just about finding the banks who know it!

Proposals for changes to the VAT option to tax regime

In this article, [Andrea Clarkson](#), and [Helen Whitfield](#) from PwC's real estate indirect tax team outlines some of the key proposed changes.

In August 2007, HM Revenue & Customs (HMRC) issued its proposals for the redraft of the value added tax (VAT) option to tax regime for consultation to those who had responded to the previous consultations. HMRC has taken the opportunity to reorder the legislation which makes it somewhat easier to follow. The suggested provisions relating to the revocation of the option to tax have also been incorporated as we approach the 20th anniversary of what was known as the election to waive exemption (this wording has been replaced in the legislation by the now more widely used 'option to tax').

VAT groups

Options to tax made by a member of a VAT group apply to all existing VAT group members and any companies which become members of the group subsequent to that option. Currently, it continues to apply indefinitely to companies after they leave the VAT group, even if they do not have any interest in the property. Tracking options to tax over a period of years and possibly through several VAT group registrations have often proved very difficult for both the taxpayer and HMRC.

Under the proposed legislation, subject to certain conditions, once a company leaves a VAT group it will no longer be associated with other VAT group members for the purposes of any option to tax. This would apply in the following circumstances:

- if the business is no longer a member of the VAT group, has no connection with a member of the VAT group and does not have an interest in the opted property, the option to tax made by the VAT group will not apply to it. This is a welcome change and will greatly simplify compliance for any acquirer of a company which was previously VAT grouped with companies with large property portfolios;

- if the business is no longer a member of the VAT group but still has an interest in the opted property, it will be allowed to revoke the option to tax provided that it has had an interest in the property and been a relevant associate of the person who opted for at least 20 years and the revocation conditions (see below) are met. Again the ability of a person, previously VAT grouped with the company which opted, to apply from revocation is an important addition to the relevant provisions; or
- in certain other circumstances, if the business receives permission from HMRC.

One of the other proposals which will impact on companies which have been in a VAT group is the automatic revocation of the option to tax if a person does not have an interest in the land for 10 years. This means that a company leaving a VAT group with a property opted by another group member could find that that option has lapsed because the person who opted has not has an interest for 10 years.

It is clearly going to be complex to determine whether or not the option to tax continues to apply to some businesses that have left VAT groups and it may be difficult to track options which have been made by other businesses within a VAT group.

Revoking the option

Cooling off period

The proposals are to extend the initial period for revocation from three to six months subject to no supplies of the property having been made and provided that there has been no use of the property for the businesses own purposes.

Notification of the revocation should be made to HMRC within the six-month deadline and businesses may be required to repay input tax which has been recovered in relation to the property.

HMRC had previously suggested a 12-month cooling off period but on condition that the business had not recovered input tax in respect of the property. Businesses felt this would be of little value; the ability to recover input tax, revoke and repay the input tax is key.

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Proposals for changes to the VAT option to tax regime

20-year revocation

The suggested conditions to be met when an option to tax is revoked after 20 years are also explained. The first such revocations can be exercised from August 2009 and the conditions are as follows:

- the business no longer has a right in the property; or
- the business has held the right for 20 years or longer and the option was exercised 20 years ago; the property is not a capital item; there has been no supply at below market value in the last 10 years; and no prepayments have been received in relation to supplies of the property which will be made after the revocation.

If these conditions are met then businesses need only to notify HMRC of their revocation. In the event that these conditions are not met, then provided the 20-year condition is met, the option may still be revoked but the prior permission of HMRC will be required.

Irrevocable election

The irrevocable election is a new concept which is to be introduced in the rewritten schedule 10. A business making an irrevocable election will be treated as opting every property in which an interest is acquired from a time immediately prior to the acquisition. The irrevocable election will only require one notification and no subsequent notifications will be necessary.

This will clearly be helpful to ensure that options to tax are not missed, particularly in relation to the option to tax requirements for transfers of a going concern.

Businesses will be able to remove specific properties from the irrevocable election by notifying HMRC that the election is not intended to apply to the property. In addition, it will be possible to make a separate notification of an option to tax prior to acquisition of the property if a business wishes to recover input tax prior to acquisition.



Residential use

Under the proposals, a business which intends to change a non-residential building to residential would need to issue a certificate to the supplier to confirm this intention so that the option to tax is disapplied. Certificates may also be issued by intermediaries where it is the intention of the ultimate purchaser to

change the building's use to residential. However, none of the certificates can be retrospective and the intermediary must already be in receipt of a certificate issued to them by the ultimate purchaser or a further intermediary, i.e. there must be a chain of certificates from the ultimate purchaser to the original supplier of the land before the supply takes place.

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Proposals for changes to the VAT option to tax regime

These conditions will also apply to certificates issued by relevant housing associations in relation to land which will be used in the construction of dwellings or for a relevant residential purpose.

Anti-avoidance

The circumstances in which the disapplication of the option to tax provisions will apply remain largely unchanged. However, further legislation has been proposed in relation to the condition which defines the exempt use of a property. Previously the property should be occupied for 'wholly or mainly eligible purposes', i.e. wholly or mainly taxable use, otherwise the option to tax may be disappplied if the other conditions were also met. This definition was open to interpretation although HMRC's policy is that businesses should be at least 80% taxable.

The wording in the draft legislation specifies that a building should be occupied for 'wholly or substantially wholly eligible purposes', if disapplication is not to be considered. This is then defined in the relevant notice (with the effect of law) as being at least 80% taxable or at least 78% taxable at the discretion of HMRC and where there is no avoidance motive. HMRC does not expand on why it has chosen 78%.

In addition the proposals are that ATMs (cash machines) will be excluded from the term 'occupation' for the purposes of the disapplication of the option to tax. HMRC has not taken the opportunity to introduce a *de minimis* limit for the area of occupation for exempt purposes by a financier or someone connected with the grantor. This means that large properties are still unable to be transferred under the going concern provisions if there is

any occupation by someone connected to the grantor or the person financing the acquisition, regardless of the fact that no avoidance is intended and the area concerned may be a very small part of the whole building or complex.

Option to tax – land v buildings

The draft rules propose that an option to tax made on an existing building will continue to apply to the land on which the building stood and any new building constructed on the site.

There will be an opportunity to exclude a new building from the option to tax by notifying HMRC that you do not wish the option to apply. This must be notified prior to granting an interest in it, occupation or completion, whichever is the earlier.



What does the future hold for UK property fund vehicles?

In the following two articles, [Suzanne Ashwell](#), a senior manager in the PwC investment management and real estate tax team, looks at and the latest developments, and upcoming changes, for UK property funds and offshore funds.

Upon hearing the terms 'Pan-European property fund', 'global property fund', 'exciting real estate investment opportunity' and so on, it would be fair to say that thoughts do not immediately jump to UK authorised investment funds. However, this perception could soon change: statistics indicate that property investment is a significant growth area for UK authorised funds.

At 31 December 2006 assets under management in UK open ended investment companies (OEICs) and authorised unit trusts (AUTs) had reached £410 billion of which only 3% related to property funds. However, this masks the rapid growth of property investment funds which accounted for in excess of 20% of total net retail sales in 2006.

As UCITS III prohibits direct property investment we are seeing an increasing number of UK funds set up as non-UCITS retail schemes (NURSSs) to allow the general public easy access to real estate investment in a regulated environment.

Changes to be introduced in 2008 should further accelerate this trend as the Financial Services Authority is due to introduce new rules permitting the use

of intermediate holding companies to invest in real estate, dispensing with the current requirement to obtain waivers to use such structure, provided that certain requirements are adhered to.

In addition to the improved regulatory position, the UK tax environment is also changing with the introduction of the property authorised investment fund (PAIF) regime which will be an elective regime for UK authorised funds. Heralded as the 'open-ended alternative to REITs' this regime seeks to replicate many of the existing benefits of the REIT regime, albeit with slightly differing conditions for compliance, and will be targeted specifically at retail investors.

PAIFs will be structured as OEICs to allow consistency of treaty access, requiring conversion of existing AUTs if they wish to elect into the regime. All income and gains relating to the property investment business are proposed to be exempt from tax (subject to certain pre-entry and cessation conditions). The tax treatment of other income will mirror the existing tax treatment for AUTs and OEICs which are subject to corporation tax on taxable income at a rate of 20% and are exempt from tax on chargeable gains and certain

items accounted for as capital profits. In a similar manner to REITs, distributions will follow a prescribed form with the tax treatment being dependent on investor profile.

These developments, as well as the recent introduction of REITs in the UK, have established a real range of alternative investment options for UK retail investors in the property sector.

In a related development that affects offshore investment products targeted at UK investors, an offshore funds discussion paper was issued as part of the Chancellor's Pre-Budget Report on 9 October 2007. The proposals in the discussion paper have been put forward as a move to modernise the current regime with a stated aim of simplification and providing increased certainty to investors. Amongst other things, the proposals suggest moving away from the current regulatory definition in establishing whether a non-resident fund will be caught by these rules and looking instead to a characteristics-based approach in determining whether a non-resident fund will be within the rules. This is discussed in more detail at the end of this article.

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What does the future hold for UK property fund vehicles?

UK investors in non-resident corporate funds are currently disadvantaged on disposal of their investment in foreign funds if the non-resident fund is a non-qualifying fund for the purposes of the UK offshore fund rules. However, under the current rules many non-resident corporate real estate funds may not be caught as the commercial realities of the real estate investment cycle typically drive restrictions on share redemptions and early exits from limited life funds. The terms of investment are therefore often such that these funds would fall outside of the existing regime.

In contrast, the proposed changes may now catch an increasing number of non-resident real estate funds which could become less attractive to UK retail investors if the fund was unable to obtain reporting fund status. Faced with a choice of having gains on disposals of shares in non-reporting funds being subject to UK income tax (at 40% higher rate) rather than capital gains tax at the proposed flat rate of 18%, some UK retail investors may look to UK authorised funds as a preferred alternative.



HMRC proposals may affect offshore real estate funds

The UK offshore fund rules were introduced in the mid 1980s as anti-avoidance legislation to prevent UK persons from rolling up income offshore and then returning that income to the UK in such a form as would receive capital gains tax treatment with associated benefits. Under the current offshore funds regime, UK tax payers investing in non-resident corporate funds are disadvantaged on disposal of their investment in foreign funds if the non-resident fund is a non-qualifying fund in which they have a material interest.

The broad effect of the legislation is that any gain realised by a UK resident investor on the disposal of a material interest in an offshore fund will be taxed as income (an offshore income gain) unless the offshore fund has been certified as a distributing fund by HMRC for each accounting period throughout the entire time the UK investor has held that material interest.

If an offshore fund does not obtain this certification then UK tax paying investors do not benefit from the potentially lower effective tax rate applicable to capital/chargeable gains and are instead taxed on any gain on disposal at their marginal rate applicable to income.

In order to be certified as a distributing fund the current rules require an offshore fund to physically distribute annually the higher of:

- 85% of the fund's accounts income; and
- 85% of the fund's UK equivalent profits (UKEP) calculated as if it were a notional UK company, albeit not subject to UK tax on chargeable gains.

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HMRC proposals may affect offshore real estate funds

However, under the current rules many non-resident corporate structures, including certain real estate funds, may not be caught as the commercial realities of the real estate investment cycle typically result in restrictions on share redemptions and early exits from limited life funds, with the result that the fund may not be viewed as open-ended. The terms of investment are therefore often such that these funds would fall outside of the existing regime, because the definition of an offshore fund, which requires them to be a collective investment scheme, in a regulatory sense, is not met.

This may now be about to change. An offshore funds discussion paper was issued as part of the Chancellor's Pre-Budget Report on 9 October 2007. The intention is to move towards a reporting fund regime where investments in such reporting funds will qualify for UK capital gains tax treatment on disposal of

their shares. Among other things, and of particular interest to the real estate industry, the proposals suggest:

- moving away from the current regulatory definition in establishing whether a non-resident fund will be caught by these rules and looking instead to a characteristics-based approach;
- excluding unit trusts which are transparent for income purposes from the regime;
- removing the requirement to pay a physical cash distribution and instead introducing a deemed distribution regime thereby permitting the roll up of income;
- allowing a fund to elect to become a reporting fund in advance of the first period for which that status would be required, thereby assisting with the marketing process for new fund launches;

- introducing a genuine commercial purpose test as part of the assessment process; and
- abolition of the material interest test which previously took UK investors out of the regime if, at the time they acquired the interest, they could not have had a reasonable expectation that they would be able to realise the value of the interest within a period of seven years.

The proposed changes may now catch an increasing number of non-resident real estate funds which could become less attractive to UK tax paying investors as a result if the fund was unable or unwilling to obtain reporting fund status. Faced with a choice of having gains on disposals of shares in non-reporting funds being subject to UK income tax (at 40% higher rate) rather than capital gains tax at the proposed flat rate of 18% UK individual investors in particular are likely to become increasingly conscious of the tax profile of their investments.

Responses to the discussion paper are due by 9 January 2008 with a view to introducing legislation in Finance Bill 2008. In order to preserve their commercial position we would encourage the managers and sponsors of non-UK resident funds to assess whether they could be within the scope of the proposed amendments to this anti-avoidance legislation.

Developments in the hotel sector

Over recent years, real estate investors have become major owners of hotels, culminating this year with the acquisition of Hilton by Blackstone. What happens in the hotel sector is therefore of considerable interest to real estate investors. PwC's publication, *Hospitality Directions – Europe*, has recently covered three areas of particular interest for investors in the UK market.



According to the latest issue, the overall outlook for the UK hotel sector in 2007 and 2008 is less optimistic than in previous years. Revenue per available room rates (RevPAR) is expected to stall as a result of declining confidence and slowing consumer demand in the face of the global credit crunch and economic uncertainty. However, the recent picture has been positive, with strong corporate demand allowing UK room rates to rise. Is this as good [as it gets for UK hotels](#) or will the sector continue to shine for a while yet?

Meanwhile Europe's [luxury hotel sector](#) has been booming and experts do not expect interest to wane in the near future. The concept of luxury is a moving target and the definitions are splintering between those for whom experience is important and those for whom trophy consumption is key. This market is being driven by young, aspirational customers, to whom differentiation is crucial. As demand evolves, the risk and the challenge for hotel operators is to satisfy the ever-changing consumer. Understanding why, when and how

consumers buy luxury are some of the insights the PwC research provides.

[Top sports venues](#) are creating a niche for themselves in this market by investing in purpose built on-site, integrated hotels. PwC research shows that this is still a relatively new phenomenon, but the availability of rooms is expected to treble in the future, providing a new business opportunity for top sporting venues.

Saving the planet – can tax and regulation help?

Richard White, a senior manager in the PwC investment management and real estate team, looks at recent survey results on how the real estate industry views environmental tax and regulation.

In July we highlighted the launch of PwC's survey of [UK companies' views on environmental tax and regulation](#). About one third of the respondents were from the construction and real estate sector. Here we provide an overview of the real estate sector results. If you wish to receive a copy of the survey results and a specific construction and real estate sector report, please contact the [UK real estate insights team](#).

The results illustrate that the sector accepts the evidence of the effect greenhouse gas (GHG) emissions are having on the environment, but then even the most sceptical onlookers no longer doubt the science. More importantly, the results show the respondents are ready to embrace change. For example:

- Over three quarters of construction and real estate companies say the climate change debate has had a significant impact of the way their organisations conduct business.
- Over 40% expect to make many changes to the way they do business over the next two to three years as a result of climate change.
- 90% of respondents believe it is very important for industry and business to minimise their environmental impact.

With regard to the factors that have the most influence on respondents' environmental behaviour and decision making, the highest ranking factors were meeting customer expectations and complying with legislation and regulation. In other words, these organisations are reacting to commands. On the other hand, seeking cost savings, a strong commercial driver, was ranked lower by construction and real estate respondents than by the wider survey population.

This perhaps hints at the continuing paradox within the sector – a general acknowledgement and enthusiasm to discuss the issue, but uncertainty as to whether the business case for change is still to be accepted, or even explored with rigour. Given the professed flexibility from this sector, it is puzzling that there been so little evident shift from conventional approaches to development and the asset management of existing portfolios.

Getting the calculations right

According to further research by the World Business Council for Sustainable Development, many companies are greatly overestimating the additional cost of building green rather than conventional construction, while underestimating the world output of GHG by buildings; the

output is actually 40% and rising fast as global construction booms.

While up to 85% of the total energy consumption and GHG emissions of a building comes from occupancy, the cost of the energy consumed as a proportion of total occupancy costs is relatively low.

Therefore, for those with a short investment horizon, there is currently little economic impetus to seek energy efficiency in building design. This is likely to remain the case while the perception exists that economic efficiency can only be achieved via greater initial capital cost with little appreciation in capital value to match expenditure. Will this always be the case? It seems inevitable that with the introduction of energy performance certificates in the UK (April 2008, applying to sales and lettings of over 5,500 sq ft) and similar initiatives elsewhere landlords are going to have to address the issue.

From discussions we have had with our clients it seems that from the tenant's perspective, although energy efficient buildings reduce occupancy costs, there is no evidence that they are willing to pass these savings on to the landlord in the form of additional rent.

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Saving the planet – can tax and regulation help?

Property owners will only invest to improve efficiency if there is a sufficient financial incentive in terms of investment returns. What the property industry is pressing for is an effective partnership with the tenant brokered by governments through tax-based incentives. The industry is lobbying for the additionally costs of development to be reclaimable, either directly or indirectly, by providing tax concessions to occupiers, the benefit of which would be passed on to the landlord in the form of additional rent.

However, rent and energy costs are only two factors among many taken into account by an occupier when considering taking a lease of a property. There is no guarantee that any occupier related savings will be passed to the landlord and so other solutions may need to be sought. Where markets do not sufficiently account for the 'true' or social cost of economic activity, in this case, where the market has misjudged the costs and benefits of addressing climate change at a building by building level, there is a market failure. PwC is helping to identify the reasons behind this issue by reviewing the entire value chain from investment decision to construction with our work with the Prince's Trust Accounting for Sustainability project, which will be reporting in December.

Energy is currently at the top of the EU priorities. The European Commission has been calling both for more efficient energy consumption and the mobilisation of resources for the take-up of cleaner energy, investment in new technologies and innovation. These objectives were recently endorsed by the EU heads of state and government in the form of the integrated climate change and energy agenda. As the EU green paper on market-based instruments for environmental and related policy purposes, "The new energy and climate policy agreed in Europe implies nothing less than a new industrial revolution over the next 10 to 15 years."

Market based instruments

Whether by influencing prices (through taxation or incentives), or setting absolute quantities (emission trading), the economic rationale for using the EU's preferred market-based instruments lies in their ability to correct market failures in a cost-effective way. Given that the construction and real estate sector believe tax and regulation are the most effective ways of influencing behaviour, this is good. Market trading schemes are the least favoured tools according to respondents to the survey, with a fifth admitting to not knowing what they are.

This is likely to change for a proportion of the respondents when the UK's Carbon Reduction Commitment (CRC) is introduced. This will apply mandatory emissions trading to cut carbon emissions from approximately 3,000 of the larger organisations by 1.1 MtC / year by 2020.

More incentives needed

Finally, the construction and real estate sector is broadly in agreement with the wider survey population that the Government needs to offer more incentives to encourage companies to invest in environmentally beneficial practices. However, the UK Government recognises that tax incentives alone will not deliver widespread energy efficient buildings. Further regulation to compel businesses to change is inevitable and the way in which the individual member states implement the European Directive on the Energy Performance of Buildings is a step in this direction.

A priority, for the sector, is to integrate the forecast regulation into new building design and existing portfolios without causing too detrimental an effect on capital costs. New builds fit neatly into the current regulatory environment but existing buildings are more complex. Managing the environmental impact

of a portfolio of existing buildings, of different ages, material types and uses is a greater challenge than a new build project. Companies should consider looking at an assessment methodology that tackles the wide range of technical and cultural issues that influence a sustainable building portfolio. By linking this to a complimentary financial model that assesses the impact on revenue and customer experience derived from achieving energy reduction targets, the building strategy that creates the most benefits can be identified. A PwC sustainable portfolio modelling tool will be showcased in the 'Sustainable Growth in Real Estate' break out session at our forthcoming client conference in Vienna.

The environmental impact of the buildings and the broader sustainability agenda have risen up the list of issues for the real estate industry dramatically over the last two years. The challenge for the industry now is to move from discussion to action.

Event

European Real Estate conference

PwC's ninth European Real Estate conference will be held in Vienna, Austria on 16 November 2007.

Business is facing unprecedented pressure to adapt to a changing world – globalisation, the emergence of new economic superpowers, technology change, demographic change, climate change and social change. What does this mean for the global economy, the real estate industry and your business?

How do you balance these huge long term pressures with the more immediate concerns of the end of yield compression, the credit crunch and the performance of the quoted real estate sector? How do you keep up with the practical issues that impact the raising and investing of capital and the way in which you run your business?

The plenary session includes a panel session chaired by Bill Kistler of the Urban Land Institute with panellists Matthew Bernstein of DB RREEF, Rainer Thaler of GE Real Estate, Karl Petrikovics and Paul MacNamara from PruPIM. In addition, there will be breakout sessions covering:

- spotlight on Germany;
- spotlight on fund structuring;
- spotlight on infrastructure supply side: what are the fundamentals around doing infrastructure deals in the European market?;
- sustainable growth in real estate;
- spotlight on CEE;
- spotlight on REITS; and
- spotlight on new developments and challenges in reporting and coping with complex group structures.

If you would like to join us at the conference, please contact the [UK real estate insights team](#) for more information.

If you have any general queries or feedback on this issue or would like to subscribe to future issues, please email the [UK real estate insights team](#).

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