

UK real estate insights

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Welcome to the latest edition of *UK real estate insights*, the first since the UK joined the select but expanding club of countries with a real estate investment trust (REIT) regime. The regime came into effect in the UK on 1 January, and nine quoted property companies converted to REIT status that day. A number of other companies have announced that they will convert during the first half of 2007. The Government's Pre-Budget Report (PBR) in December 2006 included some relaxation of the rules on REITs that will make it easier for new REITs to be launched, but what will happen now that REITs are here? There has been considerable speculation that this will result in significant consolidation in the industry. Although there has been an element of exaggeration in the commentary, it is clear that the REITs now have a competitive advantage through their tax status that they will seek to exploit if they can. The implications of [M&A activity](#) in the sector are explored by Steve Utting and Chris Mutch in an article in this edition of *UK real estate insights*. Another aspect of the introduction of REITs covered in this

issue by Martin Fleetwood is the [impact on tenants](#), a subject that has received relatively little attention.

The UK is not the only country where REITs have been making the news.

In Germany, draft REIT legislation was published in early November 2006. The major change from previous proposals is that residential property is now excluded from eligible assets. The lower house of the German parliament (Bundesrat) in a comprehensive resolution in December raised the possibility of significant amendments. These and other comments on the draft are currently being considered by the German Government and will be discussed in the upper house. Various politicians are still in favour of the inclusion of residential assets. Although the legislation is still draft and is unlikely to be agreed until at least March, the intention is that the legislation will be introduced with retroactive effect from 1 January. In view of the uncertainties, it is unlikely that anyone will seek to take advantage of the retroactive aspect of the legislation.

Italy also announced the introduction of a REIT vehicle. The Financial Law for 2007 which was approved on 21 December 2006 provides for the introduction of the Società di Investimento Immobiliare Quotate (SIIQ). Detailed rules will be published by the Ministry of Economy and Finance by 30 April 2007. Companies will be able to elect for SIIQ status for accounting periods starting after 30 June 2007. For companies with a financial year that coincides with the calendar year, the SIIQ option may therefore have effect from 1 January 2008.

In France, the changes to the Sociétés d'Investissements Immobiliers Coteés (SIIC) regime announced in December were less positive, although the regime still remains more generous than that in the UK and proposed in Germany. Shareholders or shareholders working in

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concert will not be allowed to own more than 60% of the share capital of an existing SIIC as from 1 January 2009. Any new SIIC will be subject to the new rule as from 1 January 2007. In addition, a minimum 15% free float needs to be respected, free float in this context being defined as a maximum of 2% per shareholder. SIICs will also be subject to a new 20% tax on distributions made to shareholders (other than individuals) owning directly or indirectly 10% of the share capital, if the shareholders are not subject to corporate income tax on their SIIC dividends or the tax is lower than one third of the amount that would have been paid in France. This provision would not apply where the shareholder of the SIIC is a SIIC vehicle or a foreign company with similar status.

For those that are interested in more detail on the various REIT regime changes in Europe, this will be covered in the next edition of our publication [Global Real Estate Now](#), which will be available in March, as will our annual Global Real Estate Tax CD-ROM. If you would like to be added to the mailing list for either of these please feel free to email the [UK real estate insights team](#).

The PBR was relatively quiet for the real estate industry, in comparison with the major announcements regarding REITs the previous year. In addition to the relaxation of the rules on REITs mentioned above, the key change for real estate was a further extension of anti-avoidance legislation for stamp duty land tax (SDLT). Our summary of the changes in the PBR for the real estate industry is available from our [website](#).

In the PBR, the Government also issued two further consultation documents, which re-affirmed its intention to introduce a [planning-gain supplement](#). In an article in this newsletter, Kevin Leaver examines where matters now stand. Another key message from the PBR was the importance that the Government attaches to environmental matters, a point that has been reinforced by the attention being paid this month to the impact of budget airlines. This followed the publication of the *Stern Review on the Economics of Climate Change* in October 2006. In this issue, John Manning, who leads the PricewaterhouseCoopers LLP (PwC) Environmental Tax and Regulation network and Anna Dunne who leads PwC's Real Estate Occupier Advisory Services, look at the potential impact on the real estate industry of Government [environmental policy](#).

During the autumn, with the Urban Land Institute (ULI), we have been conducting interviews across Europe for the 2007 issue of *Emerging Trends in Real Estate Europe 2007*. This is always a major exercise and our thanks go to our many clients who have participated in this process. As in previous years, the report will be launched at the [ULI's annual Paris conference](#), which takes place on 7 February. There will be a [UK launch](#) on 27 February in London. PwC also had its annual European Real Estate conference in Paris last November. The venue seated 400 and was full to capacity. We are delighted with the very positive feedback that we received from those who attended. It is difficult to believe the extent to which this event has grown over the last few years, and we now also have similar events in Asia and Latin America. Anyone who wants to receive slide packs from any of these events please email the [UK real estate insights team](#).

One of the less positive comments to come out of the Emerging Trends interview process was a concern about rising construction cost, one of the side effects of which is an increased level of dispute. This ties up with the evidence from our forensic accounting team that acts as expert witnesses in [construction disputes](#), and is seeing an increasing

demand for their services. In an article in this issue, based upon their breakout session presentation at our conference in Paris, Anthony Morgan and Adrian Welch explore some of the issues that have arisen in cases involving joint ventures and consortia.

One of the other specialist areas in which PwC has a particularly strong reputation is Islamic finance. We have recently had some changes in the team. Mohammed Amin, a partner in our Manchester office, has recently taken over as our tax leader in this area. Ebrahim Karolia, a senior manager who is another of our experts in this area, has recently moved to our Bahrain office to develop our expertise there. This issue of *UK real estate insights* includes an article by Mohammed Amin on the developing area of [shared ownership](#).

I trust that the broad range of topics covered in the current issue means that there is something to suit all tastes. If you have any feedback or subjects that you would like to have covered in future issues or at future seminars and events, please feel free to email the [UK real estate insights team](#).

[John Forbes](#)
PricewaterhouseCoopers Real Estate network leader

REITs – M&A and financial due diligence

1 January 2007 saw the UK join the select but expanding club of countries with a REIT regime – a UK listed vehicle that will be exempt from corporation tax and capital gains tax for property assets. Nine companies converted to REIT status on that day and in the next few months more announcements are expected to be made, not only from property investment companies, but private property funds and operational businesses (for example, pub chains, nursing homes and hoteliers) that will separate out the operating business from the property business.

The legislation does not allow occupiers to own the REIT, but nonetheless this can be an interesting exit route through the separation of the asset from the residual business. The quoted property sector is therefore seeing a seismic shift in value as property investment companies announce plans to convert to REITs and property rich companies consider using REITs as a tax efficient divestment or operating strategy.

From the perspective of property companies becoming REITs, the attention is not so much the immediate issues surrounding conversion, but on the strategy that will follow. For many this includes growth and in particular, growth by acquisition. This is certainly the trend that would be expected from looking at other countries – historically in the United States and more recently in France.

One of the advantages that REITs hold in corporate acquisitions is their capacity to use their tax exempt status to wash out the inherent deferred tax liabilities in the companies to be acquired. The conversion to REIT status of the newly acquired subsidiary will require the acquiring company to pay a one-off charge to HM Treasury, equivalent to 2% of the value of the property portfolio, but



the company will subsequently be able to dispose of properties without triggering a tax liability on subsequent or inherited capital gains. This gives the REIT a competitive advantage.

The increased focus on income, and thus on reducing costs, also creates an impetus for consolidation. Unfortunately, the press attention that the introduction of REITs has attracted, together with the broader impact of weight of capital, means that the market is highly competitive and the process of

identifying suitable targets can be difficult. The potential for consolidation has been so widely reported it has created an expectation that has pushed up prices. Despite this, it is expected that there will be an increase in M&A activity. Exploiting the tax advantaged status of REITs, as well as the SDLT advantage of acquiring shares in companies rather than direct property, means that more of these transactions are expected to be corporate rather than portfolio acquisitions. Traditionally the real estate industry in the UK has been more

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accustomed to direct asset acquisitions than corporate acquisitions, although in recent years there has been an increase in transactions involving property held in special purpose vehicles. In the last issue of *UK real estate insights*, we looked at the way in which an operating business rich in real estate assets can restructure the way in which those assets are held in order to provide additional benefits, particularly in the way that investors and lenders value those assets. This involves splitting the asset into an operating company (Opco) and property company (Propco). The development of Opco/Propco structures has increased the availability of assets held in a structure suitable for corporate disposal.

What does this mean for the way in which transactions are undertaken?

Any organisation considering a deal needs to validate all the assumptions it is making about that deal whether this is on the buy side, or the sell side, or in a bid defence situation. The key components of financial due diligence are substantiating revenue and maintainable earnings (driven by the properties rent roll, lease profile, property outgoings and other non property income and expenses) as well as market due diligence and deal structuring.

Financial due diligence will help analyse and validate all the financial, tax, commercial, operational and strategic assumptions being made. It uses past trading experience and the current status to form a view of the future and confirms that there are no black holes being acquired in a corporate shell. For those organisations which have historically

bought property as assets and are not familiar with buying corporate vehicles these black holes come in many guises, such as pension liabilities, employee reward and bonus schemes, change of ownership clauses and associated payments, cash versus accounting rules for rent roll, including treatment of lease incentives (rent free periods and fit-out costs), non-recoverable service charges, marketing costs and maintenance funds.

In determining the approach to financial due diligence, a key question for the buyer is not only what, but when? The appropriate scope for financial due diligence is clearly extremely important, but so is the timing. A key feature of real estate markets in recent years has been the impact of weight of capital – too much money chasing too little asset. This has not only driven up prices, but has

also made the acquisition process highly competitive. Many disposals are now conducted as competitive auctions with large numbers of bidders. At the early stages of bidding, potential buyers will want to maximise their bids but will not want to undertake extensive due diligence when there is no certainty of winning.

These same issues give rise also to concerns for the seller. In a highly competitive environment with many bidders, the seller may be concerned that the cost of due diligence may deter potential bidders, particularly if multiple bidders are incurring full due diligence costs. A common approach to this issue is that full due diligence does not take place until a single bidder has exclusivity. Whilst this may reduce the level of uncertainty for the bidder, it raises the

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risk of the buyer attempting to reduce the price during the acquisition process. As an alternative method of keeping multiple bidders in the process the seller may opt for a sell side (vendor) due diligence approach. The seller engages in financial due diligence ahead of the auction process. In addition to encouraging multiple bidders to remain in the process, this will allow the sellers to control the disposal process and speed up the eventual sale. This can help establish the highest price for their business along with adding credibility to the facts, figures and information provided in the sales memorandum. The approach will identify the black holes earlier to the sell side management team which in turn helps pricing decisions and clarification of the level of gearing the structure will support.

Supporting the transaction will be a sale and purchase agreement (SPA). Again, an SPA for a corporate disposal as opposed to a straight-forward asset sale may be new ground for some. The SPA is the final transactional document(s) which encapsulates the commercial and value objectives of buyer or seller, bridging the gap between financial advisers, lawyers, due diligence findings and tax

structuring. It is also the document which determines the purchase price mechanics of the deal and will allow sophisticated buyers and sellers to chip away at the headline price through the pricing mechanism. An increasingly common approach is a locked box mechanism in which normalised working capital and pre-determined accounting treatments are used to fix a price at a point in time prior to completion. The buyer will use the benefit of various protections introduced in the SPA to prevent the seller extracting value and in this way it is possible to eliminate the need for any financial accounts at completion.

It is also worth noting that M&A activity will involve corporate law and a transaction may give rise to financial assistance, a complex section in the Companies Act which can be easily addressed, but can make an acquisition in which the target's property is used as security to finance the deal illegal. The latest Companies Act was eight years in the making and received Royal Assent on 8 November 2006. It is expected to be fully in force by October 2008. A key amendment to the current Act is that the

prohibition on the provision of financial assistance will no longer apply to private companies, although there is no change in the legislation for public companies. Financial assistance is a matter for an acquirer's legal counsel to identify but should be fairly high up a buyer's checklist.

In the context of acquisitions by REITs, a further layer of complexity is the REIT investors' expectation that there will be low or no tax costs going forward. There are two aspects to this. First there is the past – does the vendor group have outstanding tax issues which have not been resolved and if so, has adequate provision been made in the accounts? Large tax adjustments after a target has been acquired will be highlighted in a low tax paying REIT and will not be forgiven by the REIT's investors. There may be some past hidden traps, for example, transfers intra group of assets followed by subsequent third party disposals. If there is no election to fix the disposal price on the third party sale, any unexpected large clawback of capital allowances will result in large tax exempt profits which would have to be distributed with unexpected cash

demands on the group. Secondly, the buyer needs to consider what procedures and systems are required from day one to ensure that the target does not enter into transactions, e.g. disposals of recently developed property, which would lead to a breach of the REIT regulations.

REITs potentially offer an attractive exit route. Vendors who prepare for sale will maximise their returns but they need to know where the black holes are so that they can address them before disposal and to prevent price erosion. Smart buyers will focus not just on usual due diligence procedures but will concentrate on aspects which would affect their REIT status and use this to get the best price. Consolidation plays may be a little way off as the market initially comes to terms with new entrants but experienced deal doers are already identifying potential opportunities and value drivers, leading to a very exciting time ahead for some and challenges for others.

[Steve Utting](#) is the partner who leads our real estate Transaction Services team.

[Chris Mutch](#) is a senior manager in the same team.

REITs – Benefits for tenants

After a long wait, January 2007 has finally dawned and with it arrives the reality of the UK REIT regime. Many forests have been felled over the last two years to provide the paper for the acres of newsprint that have been devoted to this subject. Royal babies aside, rarely has the birth of anything, especially tax legislation, prompted so much discussion and comment.

The high majority of comment has so far been focussed on whether companies should convert to REITs, the pros and cons of doing so and, in particular, the associated tax cost of conversion. Tables of figures have been produced showing, for many quoted property groups, the level of pregnant capital gain they currently carry compared with the 2% market value conversion charge – the REIT entry price for eliminating that pregnant gain.

Commanding much less press comment are the potential advantages for two other populations of property-interested people – the occupiers who are (or will be) the tenants of REITs, and property rich entrepreneurs. Whilst the latter may be unable to convert to REIT status, they may well be able to use REITs as an attractive [exit route](#), using a REITs tax exempt status as a lever to maximise value on a disposal. This is discussed in more detail in another article in this edition of *UK real estate insights*.

For the tenants of REITs the message is quite straightforward – the dynamics of many of the transactions they typically negotiate with landlords may have just changed very significantly. Historically,



the structure of the UK tax regime has meant that transactions such as tenant inducements and exiting onerous leases have created a tension between the landlord and the tenant. Understandably, where the landlord is making a payment as an inducement for a tenant to enter into a lease, the landlord will be seeking to structure the payment as tax efficiently as possible. Typically, this will mean ensuring the payment is tax deductible against the rental income paid by the tenant. Almost inevitably, the result of this

is that the payment is not tax efficient when viewed from the tenant's perspective.

A frequent example of this is where the landlord makes a contribution towards the tenant's fit-out costs. By ensuring that the contribution is specifically directed towards fit-out costs which will qualify as plant (for example, specialist lighting) the landlord will be able to claim capital allowances on all, or part, of the contribution and offset them against the rental income. However, as a

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consequence of this the tenant will now have incurred less expenditure on plant and will suffer a reduced capital allowances claim as a result.

Another example is where a tenant seeks to make a payment to a landlord to exit an onerous lease. Such a payment is viewed as capital for tax purposes, resulting in there being no tax deduction available for the tenant, and the landlord being taxed on the receipt as a capital gain. Attempts to secure a tax deduction for the tenant can result in the receipt being taxed as a rental income receipt in the hands of the landlord – not always a desirable outcome.

Bridging the gap between the tenant's and landlord's tax objectives can be extremely difficult.

However, where the landlord is a REIT, and the payment concerned forms part of the REIT's tax exempt property rental business, that historic position is no longer the same. In principle, all receipts enjoyed by a REIT in respect of its property rental business are tax exempt and securing a tax deduction for payments relating to a tax exempt activity is not important. This should allow new lines of dialogue to be entered

into by tenants and landlords, where both parties now re-focus; firstly, on the post-tax cost/benefit of lease inducements, onerous lease payments etc. and secondly, on how they can be structured efficiently and effectively under the REIT regime. Of course, in the conduct of these discussions the REIT landlord will need to take account of the new income/capital distinction introduced by the REIT legislation – the objective of this is to ensure that 90% of the income profits of the exempt property rental business have to be distributed each year. However, capital gains do not have to be distributed.

Even in cases where the landlord is not converting to REIT status, both landlord and tenant need to be mindful of the impact of the arrival of a tax exempt competitor, and it is therefore a good time to be reviewing the post tax impact of lease arrangements to ensure that the post tax result achieves the same objective as the pre-tax one.

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Planning-gain supplement

In 2005, the Government issued a consultation document proposing the introduction of a planning-gain supplement (PGS). PGS is to be levied to finance the infrastructure needed to support new housing. A number of concerns were raised by those responding to the consultation before the February 2006 deadline, followed by a long period of silence. However, in the PBR 2006, the Government issued two further consultation documents, which re-affirmed its intention to introduce PGS. In this article, Kevin Leaver examines where matters now stand.

What is the planning-gain supplement?

PGS is intended to capture a proportion of the uplift in the value of land upon the grant of planning permission. The uplift will be calculated as the market value of the land immediately following the grant of full planning permission (the planning value) less the market value of the land immediately prior to the grant (the current use value). The uplift will then be assessed at the PGS rate to calculate the levy that is due. Unfortunately, the Government has not announced what the PGS rate will be but says that the charge will be 'modest'.

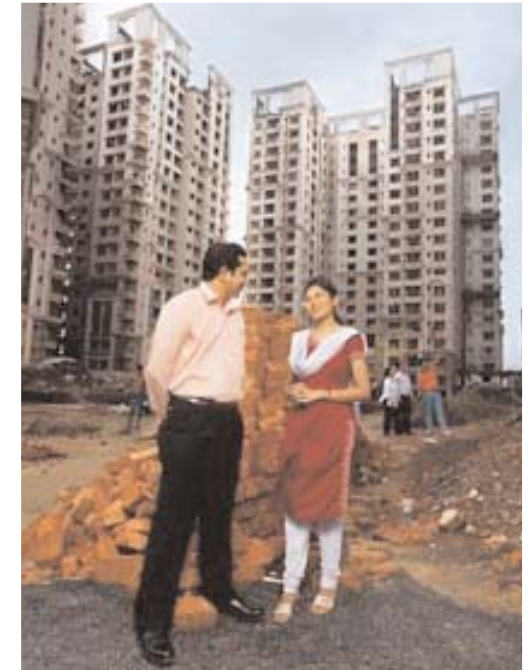
PGS will be collected on both residential and non-residential land although home extensions are to be excluded and it is likely that there will also be an exemption for certain smaller developments. Although the PGS is based on valuations at the time planning permission is granted, the charge is payable by the developer at the time development commences. This may of course be someone different from the person who applied for and benefited from the planning permission and developers who acquire sites on which planning

permission has already been granted will need to allow for the potential PGS liability when considering the price they offer for the site.

The latest consultation documents

Respondents to the original consultation raised a number of issues regarding the administration and valuation aspects of the PGS proposals and the December 2006 consultation documents aim to address those concerns and invite further response on certain matters.

It is proposed that before commencing a development, the developer will apply to HM Revenue & Customs (HMRC) for a Development Start Notice. That application will be accompanied by a PGS return that includes a self-assessment of the PGS. At that stage, HMRC will make preliminary checks on the submissions and issue the Development Start Notice. The developer will then have up to 60 days from the issue of that notice to pay the PGS due. This means that the developer has to fund the PGS at a time when there are no proceeds from the development, which could cause cash flow problems. HMRC has acknowledged that a number of



respondents raised this concern but has said the PGS is simply an additional cost of the development that needs to be budgeted for as part of the funding requirement.

HMRC will subsequently make more detailed enquiries into a number of the PGS returns, some selected at random, others where certain risk assessment

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criteria exist. If HMRC discovers that a development has commenced without a PGS return having been filed, or without the PGS having been paid, it can issue a Development Stop Notice, which will render continuation of the development illegal. However, if by that stage, the development has been completed, HMRC will be able to recover any unpaid PGS from whoever owns the development at that point. It will therefore be necessary for anyone acquiring a development to verify that the PGS liability has been settled and it is proposed that some form of public register will be established enabling purchasers to make checks.

In addition to being able to terminate a development through the issue of a Development Stop Notice, HMRC is proposing a number of measures to

make PGS effective. This will include the application of interest and possibly penalties where PGS is underpaid, the possible application of distraint, court proceedings or insolvency proceedings for collection of unpaid PGS and the inclusion of PGS mitigation within the tax avoidance disclosure regime, despite the fact that it is not being labelled as a tax.

PGS is similar in concept to a number of taxes that have been introduced in the past (for example, development land tax). The predecessors were unpopular, and the majority of the concerns about them centred on disputes over valuation. The Government has learnt from the past and the second consultation document issued in December concentrates on the valuation aspects of the PGS.

PGS is to be calculated based on valuations at the date of a relevant planning permission, being the date when outstanding key details (the reserved matters) relating to the proposed development are approved. Phased developments and re-planning applications are likely to involve a number of relevant planning permissions and hence, a number of PGS payments. For the purposes of the PGS calculation, it is assumed that the landowner holds a freehold interest with vacant possession, even if this is not the actual interest owned at the time. The market value of the land immediately before and after the grant of planning permission is to be determined using assumptions detailed in the Royal Institution of Chartered Surveyors Appraisal and Valuation Standards (the Red Book) but the appropriate method of valuation is to be

left to the judgement of the valuer. It is therefore likely that the protracted valuation arguments of the development land tax era will be a feature of the PGS. A number of respondents to the original consultation requested there to be some form of pre-commencement agreement of the PGS liability but HMRC appears to have ruled out such a facility on the grounds of cost and administrative complexity, which will lead to uncertainty for developers and investors.

Where to now?

The new consultation documents confirm that the earliest date on which PGS will be enacted is now 2009, a year later than originally proposed. Moreover, it will only be implemented if, following further consultations, the Government continues to deem it to be 'workable and effective'.

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Planning-gain supplement

This suggests that the Government may itself be concerned about certain aspects of the proposals and that ultimately, the PGS may not come to fruition.

The general impression however is that the Government remains committed to introducing the PGS. Before it does so, it will need to address a number of the key concerns expressed at the time of the original consultation which remain unanswered.

It is vital that the Government announces the PGS rate so developers have some idea of the charge. Developers will also need to know the extent to which PGS will result in a scaling-back of the planning obligations that are currently imposed by local planning authorities under section 106 of the Town and Country Planning Act 1990 (Section 106). The Government has said the introduction of PGS will result in a reduction of Section 106 obligations so that those obligations should only relate to matters directly relevant to the proposed development site and to the provision of affordable housing but it is unclear exactly how much Section 106 will be curtailed in practice.

As noted above, there also remain a number of concerns about the valuation aspects of the proposals. What level of valuation tolerance will be accepted? How quickly will valuation disputes be resolved? Will the Valuation Office Agency (VOA) have adequate resources? In certain cases, time pressures may force developers to accept VOA proposals, compromising an equitable review process, and generally, it is highly likely that there will be a significant additional burden for developers in defending valuations, in terms of both cost and administration.

If PGS is to be introduced, it will also be necessary to introduce some clear-cut transitional provisions to make allowance for the wide range of existing situations that could potentially be affected by the PGS regime.

Conclusions

Many have expressed the view that the imposition of a levy upon starting development is likely to hinder rather than assist the supply of new housing. Others believe that PGS is plagued by the same implementation problems that caused its predecessors to be scrapped, and it may face the same fate. However,



it appears that the Government believes that PGS is the way forward and that the concerns that have been raised can be satisfactorily addressed.

The closing date for responses to the latest consultation documents is 28 February 2007 and interested parties may wish to contribute, either directly or via industry bodies who intend to respond.

In the absence of details of the PGS rate, the impact on Section 106 and the

transitional provisions, it may be too early to take action at this point solely to pre-empt the introduction of PGS, and it might be disadvantageous to do so, but it is clear that landowners and developers need to be conscious of the possible introduction of PGS in their planning and that they should monitor the situation carefully.

[Kevin Leaver](#) is a tax director who specialises in advising entrepreneurs and private clients with real estate interests.

Building greener real estate

The publication of the *Stern Review on the Economics of Climate Change* in October 2006 and its conclusion that the world has to act now on climate change or face devastating economic consequences, has focussed attention on environmental policy. Carbon emissions have already increased global temperatures by half a degree Celsius. Without remedial action there is more than a 75% chance of global temperatures rising by between two and three degrees Celsius over the next 50 years. This level of increase in temperatures could reduce global economic output by 3%. There is also a 50% chance that average global temperatures could rise by five degrees Celsius and this level of increase in temperatures could reduce global economic output by 10%. The poorest countries would lose more than this.

There is increasing political consensus that major action to curb carbon emissions is essential. Much of the political focus in the UK has been directed at transport and political parties in this country have accepted the need to increase the cost of flying and driving. Whilst this may have an indirect impact on real estate, for example in the retail and the hotel sectors, real estate is also more directly on the agenda. As buildings account for 45% of the carbon emissions in the UK the commercial property sector is also at the forefront of Government thinking.

Changing behaviour through the tax system

Stern recommended that carbon should be priced as a way of influencing behaviour. One of the ways in which carbon can be priced is through the tax system, either by taxing emissions or by providing tax incentives for property owners and occupiers to reduce emissions from buildings. The PBR in December 2006 certainly had a green tint to it. Commentary on the environment occupied nearly a quarter of the appropriately titled Green Book. In the PBR, the Chancellor announced a target

of all new homes being carbon zero within 10 years and for a short-term stamp duty exemption to be offered as an encouragement. What other tax sticks and carrots could the Government offer for developers and occupiers to move towards greener buildings in the future?

Energy efficiency

The tax system already addresses inefficient use of fossil fuel energy through the climate change levy (CCL), a tax added to the energy bills of commercial property occupiers. The Chancellor announced that this will increase from April 2007.

In future, there could be new carbon taxes specifically geared to the carbon emissions. These could encourage more energy efficiency and the use of alternative energies designed into buildings.

The existing tax system could be adapted to influence the type of buildings that are built and occupied. Business rates could be graduated to make energy usage an explicit factor in determining charges. Some form of energy efficiency rating, like the Building Research

Establishment Environmental Assessment Method (BREEAM), or the certification in the new Home Information Packs, could be factored into valuations so that occupiers of more energy efficient buildings receive a discount and the less energy efficient incur a penalty.

Brownfield or greenfield?

Parts of the tax system are currently tilted in favour of greenfield developments. For example, the redevelopment of a brownfield site is likely to generate a large amount of waste by virtue of default dig and dump work by developers. Some of this waste may be recycled but much goes to landfill. And landfill tax, currently charged at £21 per tonne, is on a £3 per year escalator heading to £35 or more per tonne.

Greenfield development inevitably consumes more resources through the need for more infrastructure. The energy cost implicit in development will grow as the price of carbon is increasingly reflected through higher tax or the requirement for property owners and occupiers to join in carbon trading schemes.

Building greener real estate

Rebuild or renovate?

Demolish and start again or renovate? In terms of carbon emissions and the efficient use of resources, refurbishment of the existing building stock is likely to be a better option. But the tax system does not always work to best support this.

The classic example is VAT on new residential property for which there is no VAT cost for the purchaser or developer. By contrast, improvements to existing houses are subject to VAT imposing an additional 5% or 17.5% cost.

Likewise, for corporate owner occupiers, there is little tax relief for the refurbishment of properties to bring them up to modern day standards of energy efficiency. The Carbon Trust's Low-Carbon Building Accelerator (LCBA) initiative could be used to generate the metrics against which tax relief could be granted.

The playing field is tilted towards a higher energy, higher resource use option. If the Government is true to its stated intent of tackling climate change, relatively higher taxes levied on new building and tax reliefs granted to encourage refurbishment could be expected.

How should this be incorporated into real estate strategy?

The taxation system and, to some extent media coverage, are beginning to change the behaviour of both the real estate industry and its occupier clients. Yet planning for efficiency is still frequently viewed as an expensive luxury and without more positive financial incentives is probably not given the prominence it should deserve in real estate strategies. There are, however, a raft of actions that should be considered; some potentially at very little cost, some of these will pay back immediately, and others more so as the taxation system evolves.

All occupiers should be building into their processes for developing real estate strategies a process that automatically evaluates business requirements for real estate against implications for environmental efficiency. This may take a little development and some investment in specialist help, but it should ensure that all decisions explicitly factor in the environment for short and long term benefit. This evaluation will look at three areas; the efficiency of buildings, the efficient use of buildings, and location in terms of transport to and from buildings.



More efficient buildings

When considering whether a building is fit for operational use, always question the need for new build and when considering the need for new build or re-use, always invest in design with efficiency in mind. In particular, avoid over-specification which can be in terms of materials but, more importantly, utilisation of space. A proper understanding of space requirements cuts costs as well as promotes efficiency. Also, design to minimise energy utilisation in construction (consider where materials come from) and to minimise

energy utilisation and waste during the building's life. In the latter area, technological solutions are already available and proven and do not have to include high value capital investment. Consider the basics such as insulation, orientation and maximisation of natural light, natural air movement and thermal mass before resorting to mechanical equivalents. There is increasing scope for cost efficient investment in use of on-site alternative energy sources such as combined heat and power and thermal storage. The more these are taken up the lower the costs of design and installation will become.

[cont...](#)

Building greener real estate

More efficient use of buildings

In addition to building efficiency there is also the obvious efficiency in use. Where should policies and plans for implementing environmental behaviour sit within a company? In practice, this should affect many areas of corporate life but it is often the property department who has designed for efficiency in use and procured services to manage waste and energy consumption. Environmental behaviour should therefore have a place in real estate strategy.

Transport

Increasingly, decisions on location are at the very heart of a real estate strategy and will require an understanding of the total carbon footprint of the business i.e. how do people and products get to and from their locations. For some businesses this will be a relatively simple understanding of employee travel to work time and provision of incentives and support to cut down on the use of cars. For other businesses, in time, it may require re-design of supply chains and fundamental re-shaping of property portfolios.

Conclusion

The commercial property sector is at the forefront of Government thinking and we believe that the Government will be true to its stated aim of tackling climate change and will focus increasingly on real estate to achieve this. Consideration of environmental efficiency can already pay back. At the very least it should not be a difficult or a costly step to ensure that environmental efficiency planning becomes an accepted and important part of the development of real estate strategies and financial and taxation planning.

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Potential pitfalls in capital projects – joint ventures and consortia

High profile capital project failures have always hit the headlines and the ones we hear the most about are those projects that are publicly funded, but the same issues plague the private sector as well with scope changes and schedule delays resulting in cost overruns. Project management professionals routinely cite the balance of these three areas as the key to project success. However, matters become more complicated when considering consortia and joint ventures, as the temporary merging of organisations gives rise to more issues around resources, responsibilities, reporting and shared systems, in addition to the expected run of the mill construction problems.

As a tactical measure, many in the industry are entering into consortia and joint ventures with the intention of putting themselves in a better position to successfully deliver and to diversify and reduce their share of the risk on major projects. Joint ventures are generally formed in order to take advantage of complementary resources between operating partners, whether those resources are capital, labour and materials, local connections and suppliers, or management and technical expertise. Interestingly, bringing together resources to fill gaps in finance, materials, or skill sets actually generates new risks for the newly formed joint venture organisation.

It does not take much statistically to show that managing risk in capital projects is critical. Joint ventures and consortia are not uncommon in the PFI/PPP arena where, for a typical construction project exceeding £50 million, the expected probability weighted outcome, measured in total capital cost of a project, is 17% above its expected costs¹. And in a recent survey, contractors indicated that over 70% of their own most common sources of

project failure were attributable to poor organisation and management, lack of clarity of objectives, and poor planning and monitoring.

It may seem obvious, but bringing together operating partners to work towards a common goal requires some planning. Surprisingly, some major players in the business have shown evidence of failing to do just that, and it has landed them in the unenviable position of trying to get their projects back on track.

The financial impact of project changes and delays resulting from poor organisation, management, planning and monitoring can be disastrous, particularly in the private sector where companies forced to absorb large cost overruns may, in the worst cases, collapse under the financial strain. More often, projects end in dispute, whether litigation, arbitration, or some alternate form of dispute resolution. Dispute resolution can also be a costly exercise, and has the added disadvantage of distracting management from the job of continuing to deliver the project. Complexity increases when considering joint ventures, as questions arise not only as



to whether the joint venture is culpable, but also as to which operating partner, in whole or in part, bears the risk and responsibility for the failure. Disputes may also arise within the joint venture and further hinder progress.

Defining roles and responsibilities adequately should work towards eliminating gaps and overlaps in the

¹ Cambridge Economic Policy Associates

Potential pitfalls in capital projects – joint ventures and consortia

combined organisation, in terms of operating partners and individuals. Risk should also be defined and assigned through appropriate contracting arrangements. Other early decisions that should be addressed within joint ventures include determination as to whether to use the existing reporting systems of one of the operating partners, or begin with a clean slate and select new systems. Complications may arise depending on each partner's reporting needs, as a construction manager will likely require a different set of metrics than an electrical or mechanical contractor in order to monitor project performance.

Generally, a good project controls system will focus on key risk areas, such as change management. Reporting should include monthly accounts of budget, actual and committed costs, and forecast to complete. But reporting should also incorporate key performance indicators, such as earned value (which compares planned to actual project progress as a function of money spent), in order to provide a snapshot of project health. Key performance indicators are concise and usually require less interpretation than lengthy reports and, therefore, keep management collectively informed.

Further, project reports should be circulated and legible to both project management and executive management, in order to minimise false optimism or surprises.

While having project controls and reporting systems is a positive step, it is critical that business units and individuals are compliant with the procedures put in place. Some organisations actively work to establish a culture of compliance, while others accept the misconception that capital projects are simply fraught with complications that are most easily dealt with by side-stepping standard operating procedure. It is difficult to know in advance of entering a joint venture arrangement where each operating partner will fall on the compliance spectrum when it comes to the field management. And, while executive management may ink the deal to join forces, it is the field management who will ultimately be driving the project forward on a daily basis.

It may be difficult to predict how operating partners will perform when brought together, but it is possible to manage and mitigate the risks associated with combining organisations. One



solution for detecting potential issues before they become costly and irretrievably problematic is to employ an external third party to perform an independent review of the project, or wider programme performance.

External reviews are increasing in popularity and can incorporate any number of areas: including financial performance; project management;

change management; design and construction management; performance measuring and benchmarking; value for money analyses; risk assessment evaluation; procurement management; partnering and contract management. This type of review may be performed at regular intervals on a large and lengthy capital project, where joint ventures and consortia are not uncommon. Or these reviews can equally be applied on a

Potential pitfalls in capital projects – joint ventures and consortia

sample basis across a population of smaller capital projects that may be run by in-house construction and real estate professionals. Results can be used for purposes of continuous improvement and benchmarking, as well as highlighting good practice within an organisation.

Some general early warning signs that a project is in distress include continuing changes to project scope, budget and timescale. All projects experience change. However, depending on the type of contract and project, changes should usually level out as the project progresses. Cash flow issues are another sign of distress and could indicate that subcontractors are being paid for change orders not yet approved and, importantly, not reflected in reported forecast completion figures. Or, simply, funds may be being misappropriated.

Along reporting lines, a lack of reporting against key performance metrics, or not tracking the right metrics, can easily mask problems. While executive management may receive voluminous copies of cost reports, key performance metrics can give a snapshot of a project's health and minimise the need for subjective interpretation. Decreasing quality of communications, difficulty arranging meetings with project management and taking significant lengths of time to resolve issues are also red flags that the project may be heading for trouble.

Detecting such uncertainties should prompt management to take a look at what is happening in the field on a daily basis, particularly where joint ventures are concerned. What may be considered standard operating procedure to one operating partner may be new to the

employees of another, but virtue of differing cultures. A review may, therefore, discover an over-reliance on particular individuals and indicate a need for additional resources with specific skills and experience, or it may show that a greater emphasis needs to be placed on compliance with processes and procedures. Controls and proper reporting both within the project management team and between project/programme and executive management is essential.

Capital projects can be difficult to tackle, even for seasoned veterans of the industry. Those foundering projects we keep reading about in the news are run by some big name contractors, whether acting on their own, or in joint ventures or consortia. How does an organisation ensure that a project succeeds? It all boils down to risk management: identify

and mitigate. If organisations are to achieve their aims of delivering on time and within budget, while taking advantage of the benefits of teaming through joint ventures or consortia, preventative measures surrounding management and governance can smooth the way. It is much better for organisations to plan early than to find themselves trying to control the damage later.

[Anthony Morgan](#) is a partner advising on Capital Projects Consulting and Dispute Resolution.

[Adrian Welch](#) is a manager in the team.

Shared ownership – a new opportunity in Islamic finance

Many devout Muslims consider that Islam prohibits the receipt or payment of interest. Historically, this has precluded them from using mortgage finance for property acquisitions. Although Islamic finance has developed alternative acquisition structures that avoid the payment of interest, in a UK context, without complex tax planning, such structures typically gave rise to additional tax costs, such as double stamp duty or a lack of relief for finance costs, compared with a conventional mortgage; hence the need for legislation.

Over the last few years, tax law has been amended to facilitate property acquisition through shared ownership. The main driver for this has been a desire to make the tax system more inclusive, by creating a level playing field for Islamic housing finance compared with conventional mortgage finance. However, everyone needs to be aware of the rules as the legislation is applicable to any transaction falling within its definitions, and can benefit non-Muslims as much as Muslims.

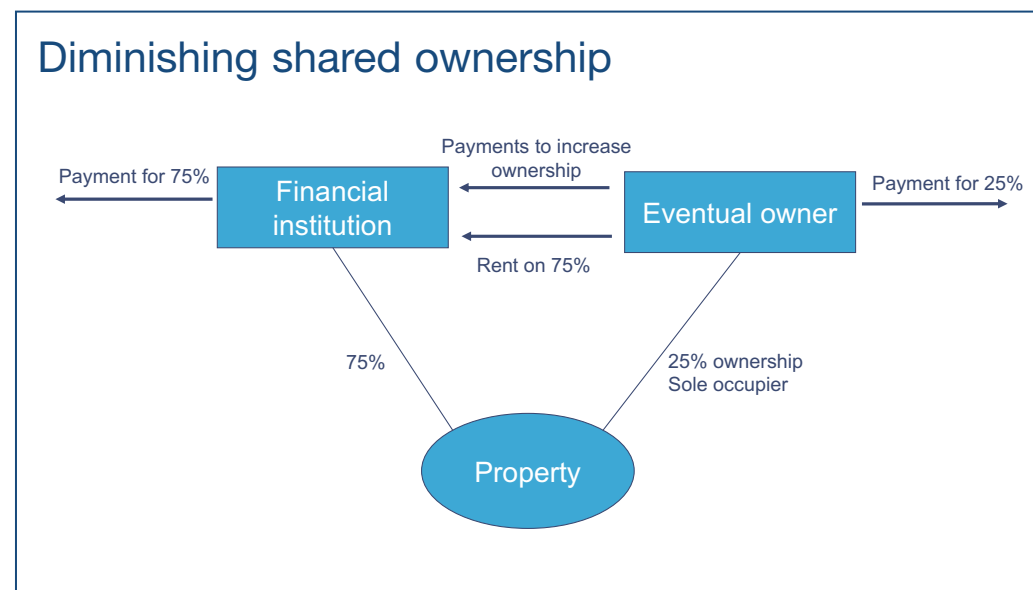
In this article, Mohammed Amin considers the current tax treatment of a common structure used for Islamic mortgages, namely diminishing shared ownership as it is called in Finance Act 2006. Although the legislation is primarily aimed at facilitating the finance of housing through a domestic mortgage equivalent, it is applicable more broadly to property finance and may provide an alternative to the Ijara arrangements usually implemented for financing real estate investment.

Shared ownership property transactions

Diminishing shared ownership is normally implemented as shown in the diagram below, where a person (the eventual owner) has sufficient funds to purchase 25% of a property, but needs finance for the other 75%.

With a conventional loan, the eventual owner would borrow 75% of the total

cost from the financial institution and have 100% beneficial ownership of the asset from the beginning, even though legal title to the asset would usually be held by the financial institution as security. Instead, with diminishing shared ownership the eventual owner and the financial institution purchase the property jointly, although for security the legal title is likely to be held entirely by the financial institution.



Shared ownership – a new opportunity in Islamic finance

The eventual owner has sole occupancy rights, but pays rent to the financial institution on that part of the property that it does not own. It then acquires the remainder of the property from the financial institution in stages.

SDLT relief

Without special relief, there would potentially be three SDLT charges on that part of the property which is financed. Firstly when the financial institution purchases the property, secondly on the lease when the financial institution rents its share of the property to the eventual owner, and finally when the eventual owner buys that share of the property from the financial institution. In contrast, SDLT would be payable only once if the buyer had taken out a conventional mortgage.

Finance Act 2003 s71A provides relief in England and Wales from the second and third SDLT charges, provided that its precise conditions are met. (S72 deals with Scotland and is not covered in this article.) Some key points to note are:

- A financial institution is defined to mean a bank, building society, or wholly owned subsidiary thereof. Partially owned subsidiaries are excluded.
- The eventual owner needs to have the right to purchase the financial institutions share of the property, but does not have to be obliged to purchase.
- The legislation is silent on the price that the eventual owner pays for buying subsequent shares in the property. Accordingly, the price could

be set at the financial institution's original cost or at market value for example.

Tax relief for finance costs

In the absence of special provisions in the diminishing shared ownership structure, the eventual owner would be regarded as paying rent to the financial institution.

This rent may or may not be a deductible cost to the eventual owner. For example, if the contract specifies that future purchases of the financial institution's share of the property are to be at original cost, then arguably the rent being paid is partly to preserve this favourable purchase option, and may therefore be a capital item rather than a deductible cost. The financial institution would also be treated as receiving rent, which may have

different tax consequences for it than receiving interest.

Accordingly, Finance Act 2005 as amended by Finance Act 2006 by the insertion of Finance Act 2005 s47A sets out a specific legislative regime for the direct tax treatment of diminishing shared ownership. Where the parties are companies, for tax purposes they are treated as if they were parties to a loan, whose original amount is the price the financial institution pays to purchase its share of the property, and where the rent or other fees paid by the eventual owner to the financial institution are treated as if they were interest.

Perhaps because this legislation was enacted several years after the SDLT relief, there are several differences from the SDLT rules that need to be borne in mind.

[cont...](#)



Shared ownership – a new opportunity in Islamic finance

- The SDLT definition of financial institution is extended in two ways. It includes “a person authorised in a jurisdiction outside the United Kingdom to receive deposits or other repayable funds from the public and to grant credits for its own account” and “a person authorised by a licence under Part 3 of the Consumer Credit Act 1974 (c 39) to carry on a consumer credit business or consumer hire business within the meaning of that Act.” Accordingly, foreign banks can take part in such transactions for direct tax purposes, but cannot benefit from the SDLT relief, which is illogical.
 - The eventual owner must be exclusively entitled to any income, profit or gain arising from the asset (apart from the rent it pays to the financial institution) and in particular any increase in the value of the asset. The legislation expressly permits the financial institution to share in losses in value, but precludes it from sharing in gains.
 - The legislation stipulates that the eventual owner “is to make payments to the financial institution amounting in aggregate to the consideration paid for the acquisition of its beneficial interest.” Accordingly, a mere option to purchase appears insufficient; the eventual owner is obliged to purchase.
- Conclusion**
- The legislative provisions for diminishing shared ownership are not consistent between SDLT and direct taxation, but may be amended in future to make them consistent. At present, they are quite narrowly drawn, but may be extended by future legislation as Islamic finance becomes more common in the UK. As mentioned above, their use is not limited to Islamic finance, and any person is able to make use of them for transactions that fit within the rules.
- [Mohammed Amin](#) is a tax partner who specialises in the structuring of transactions involving Shariah compliant finance.



UK hotels continue to celebrate buoyant trading conditions

As 2007 begins, the UK hotel sector continues to boom, with near record trading and a capital abundance driving global investment. Although repair growth rates are expected to slow in 2007 (particularly in London) many believe the UK sector has several more years revenue growth ahead, driven particularly by room rate gains, before the next turndown appears on the horizon.

In a highly competitive real estate market, hotels have become attractive real estate assets and as hotel real estate values continue to increase, a diverse range of private investors are seeking property investments with predictable income streams. A record US\$70bn of global hotel assets is expected to have been traded in 2006, a third up on 2005¹. Thanks to the continued separation of hotel ownership from hotel management (the Opco/Propco shake-up) this high level of activity is likely to continue in 2007. Another new trend in recent years has been the sheer scale of private equity investment. There has been no sign of a slow down in activity, despite concerns that unsustainable loan to value ratios continue to overheat the market. Furthermore, as buyers continue to pay high prices and interest rates rise, the leveraged positions of some private equity players are likely to become more difficult.

While InterContinental has been leading the charge out of hotel asset ownership, Hilton Group has sold its entire hotel business to its American namesake for £3.3bn, after a separation of more than 40 years. Recently Accor announced it was pursuing an asset right strategy,

stepping up its divestiture programme. De Vere Group has been acquired by Richard Balfour-Lynn's Alternative Hotel Group. Whitbread sold its Marriott hotels business in the UK for almost £1bn and Permira sold Travelodge to Dubai Investment Capital (DIC) for £675m, and then immediately purchased Principal Hotels, which it has now just sold to Alternative Asset Investment Management (AAIM).

2006 has been the best performing year for UK since the record year 2000

Biannually PricewaterhouseCoopers LLP (PwC) publishes its forecast and commentary for future hotel performance for three significant hotel key performance indicators (KPIs) (revenue per available room (repair), occupancy and room rate) for the UK as a whole, the English regions and for four key cities London, Birmingham, Manchester and Edinburgh. The next forecast will be published in March 2007.

The key message from PwC's latest hotel performance sector forecast (September 2006) is further growth, albeit decelerating, for hotels over 2007 and 2008, driven by:

- better than expected economic growth – crucial for business travel and discretionary income growth for holidays;
- sustained recovery in corporate travel volumes;
- leisure travel recovery – especially the buoyant short breaks market, partly reflecting the regeneration of some of our historic destination cities as well as new hotel concepts and strong mid-market performances; and
- few oversupply concerns.

For the UK as a whole, 2006 has been the best performing year since the record year 2000. The current boom in London is very much a case of London having the year it should have had in 2005 if the July bombings hadn't disrupted travel demand. London is the engine driving the UK at the moment, with hotels filling up and occupancies at their highest for almost 10 years. Coupled with robust room rates growth this has pushed expected double digit revenue per room (RevPAR) gains of 12.9% in 2006 (still 9.9% if you strip out inflation) – making it another record year. We expect London's average annual room rates to reach over £123 in 2008.

¹ Jones Lang La Salle

UK hotels continue to celebrate buoyant trading conditions

Outside London the picture has been more mixed, but there are also some exciting stories and reflecting this Birmingham and Edinburgh saw good RevPAR growth in 2006 and are expected to experience further solid growth over the next two years. Manchester is still absorbing past supply increases and has been a little slower. It should get back on track in 2007 as it has a dynamic hotel industry, although

further openings such as the new Hilton, the City Inn and a new Travelodge may slow growth rates.

Trouble ahead?

This strong performance is good news in a variety of ways for the sector. It means:

- Opportunities for hotels themselves to expand, refurbish and employ more people.

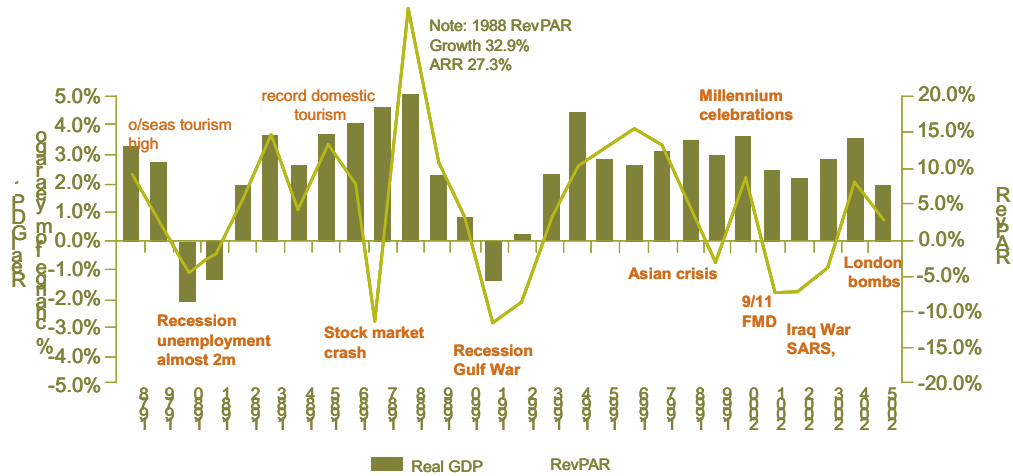
- Continued growth in terms of opportunities for investors and the development of new high quality replicable products – at home and in emerging markets.
- Increased investment in new and reinvigorated products will continue to raise the bar in terms of quality. This includes luxury brands, branded budgets and some lifestyle hotel

products as well as new concepts like extended stay hotels such as Staybridge Suites or condo hotels.

However, history dictates that the hotel sector is cyclical. There is a direct correlation to economic performance and the sector is vulnerable to a number of risks as the graph clearly shows the good

Good times and not-so-good times

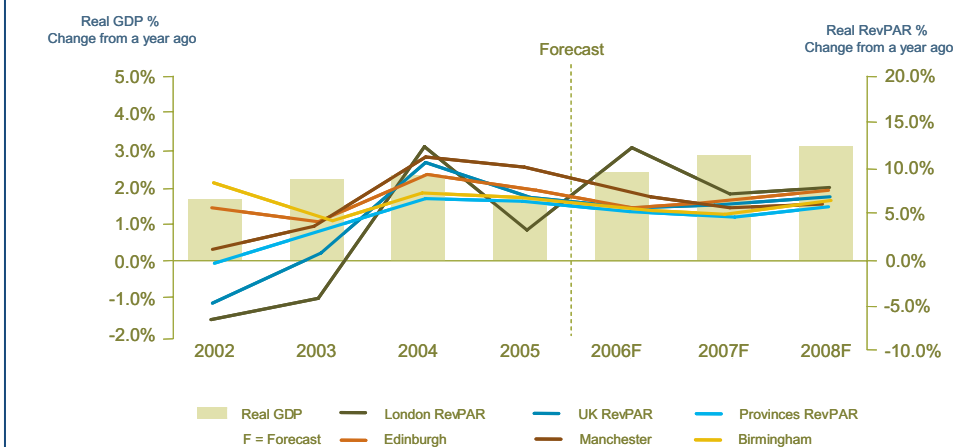
UK – Real GDP growth and revenue per available room (RevPAR) 1978 to 2005



Source: Econometric Forecasts: PricewaterhouseCoopers July 2006, Macroeconomics Data: Oxford Economics, July 2006, Benchmarking Data: Hotel Benchmark TM Survey by Deloitte, July 2006

No stopping UK hotels in key cities?

Forecast for UK and key cities over next three years



Source: Econometric Forecasts: PricewaterhouseCoopers July 2006, Macroeconomics Data: Oxford Economics, July 2006, Benchmarking Data: Hotel Benchmark TM Survey by Deloitte, July 2006

[cont...](#)

UK hotels continue to celebrate buoyant trading conditions

and not-so-good times for the sector since 1978. The inventory rolls each night and you can't store a hotel room – if you don't sell the room each night the revenue is lost.

A number of risk factors could blow performance off-course. These include:

- a harder than expected economic landing;
- rising oil and energy costs;
- further terrorism events;
- the spectre of a bed tax,
- over-supply (especially post Olympics in London); and
- a discretionary income squeeze.

Nevertheless, the sector is much savvier this time around with better quality management in place, tighter cost control and purchasing policies and little overstaffing. Luxury hotels in particular have some of the highest margins in the industry.

Tighter market conditions in key markets and slower RevPAR growth will make it harder for some companies to deliver on growth expectations and development pipelines, but there is much to play for and, despite concerns, many operators feel positive about the coming year. For example, in 2007, Marriott International expects to exceed the previous peak house profit margins last achieved in 2000. Given the limited supply of good property to invest in, the introduction of REITS should be positive, and adds an additional element to the Opco/Propco equation. The [M&A aspects of REIT transactions](#) are discussed in another article in this edition of *UK real estate insights*.

Some investors as well as hotel operators and owners will, of course, do better than others and in this competitive environment there will be the best and worst of class. Hotels need to differentiate themselves through strategy, strong brands, product and the guest experience. For those that fail to do so, the going could be tough.

[Liz Hall](#) is head of hospitality and leisure research at PwC. Further information on the survey and other hotel sector research can be found [here](#).



Publications

Global Real Estate Now

The lead story in the latest edition of *Global Real Estate Now* serves up an overview and analysis of the Emerging Trends in Real Estate series – Europe, the US and Asia Pacific – produced in conjunction with the Urban Land Institute. Whilst there are many examples of what Emerging Trends can teach the global real estate community, the articles focus on three major lessons; market maturity; investor cycles and perceptions of core. Other articles in this edition cover news from Central and Eastern Europe, the Middle East and the Americas.

Please [click here](#) to access the latest issue.



Events

PwC property derivatives seminar – 21 February 2007, London

5:00 – 7:00pm

Over the past 18 months there has been increasing interest in property derivatives from real estate funds and the industry in general. There are a number of key considerations and themes that are pertinent to funds and other end-users as well as to the financial institutions acting as counterparties. This seminar will discuss and share insights into the development of these issues as this market continues to evolve.

The seminar will be hosted by PwC property derivatives specialists and will open with Paul Ogden of CBRE/GFI delivering an overview of the current market and product developments. Following this, we will examine a number of important considerations and common questions faced by the taxation, accounting and treasury functions within the end users of this growing market.

This seminar is free of charge.

For more information, or to register, please contact [Denise Cook](#).

Emerging Trends in Real Estate® Europe 2007 – 27 February 2007, London

9.30am – 12:00pm followed by lunch

What are the best bets for real estate investment and development in 2007?

PricewaterhouseCoopers is holding a seminar on 27 February highlighting the results of the third Emerging Trends in Real Estate® Europe 2007 survey, published jointly with the Urban Land Institute. The seminar will give you insight into where to invest, what to develop, which markets are hot, which markets to avoid and how the economy and trends in capital flows will affect real estate in 2007.

If you would like to attend, please contact [Denise Cook](#).

Save the date – 24 May 2007

The PwC annual UK real estate seminar will be held on 24 May from 1:00 to 6:30pm at the Cafe Royal, London.

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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