Real Estate Derivatives

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PRRES UTS Sydney 20 January 2009
Why the initial difficulties in the UK? ... the problems

- A lack of knowledge
  - Real Estate people about derivatives
  - Derivative people about Real Estate
- Index availability
- Timing of past pushes and strong one-way capital flows
- The Life Fund ‘Catch 22’
  
  ‘The market is illiquid so life funds can’t invest in derivatives… and ... because life funds can’t invest in derivatives, the market is illiquid”
- Lack of clarity over tax treatment
  - Which regime, capital or income?
- A mismatch of knowledge and utility?
  - ‘all property’ contracts for multi-asset decisions
  - The link made through property fund managers
- Mandates

Source: Paul McNamara, Prudential Property Investment Managers (UK)
The advantages of going ‘synthetic’?
...for UK property investors

- Speed
  - Hours versus months

- Reduced cost
  - 1% versus 10%

- ‘Accuracy’
  - Target allocation levels

- Flexibility
  - Moving in and out of real estate, sectors and segments

- Lack of hassle
  - Less people involved in the chain

Source: Robin Goodchild, LaSalle Investment Management
Notional Traded £m

- UK
- France
- Germany

Q1 - Q4 2004
Q1 2005
Q2 2005
Q3 2005
Q4 2005
Q1 2006
Q2 2006
Q3 2006
Q4 2006
Q1 2007
Q2 2007
Q3 2007
Q4 2007
Q1 2008
Q2 2008
UK Interbank vs End User
Outstanding Notional £m

End User
Interbank
Survey respondents

£ 31.4 bn
Managers
(54%)

£ 26.7 bn
Owners
(46%)

• Sent to 100 IPD contributors
• Replies representing £58 bn of capital
• 48% of the IPD UK Universe
Readiness Survey – Main Points

• Investors feel they know about derivatives and are highly supportive of the market

• Keen to go beyond ‘all property’ contracts

• 3 out of 4 have a mandate to trade and the vast majority of the rest are willing to recommend their use

• Main concern – liquidity
Main Uses of Property Derivatives

- Market turning point exploitation
- Strategic asset allocation
- Tactical asset allocation
- Short-term hedging of cash position
- Long-term hedge
- Enhancing ‘alpha’

Legend:
- All Property
- Segment
Remaining Barriers to using derivatives

- Internal systems
- Understanding
- Index (segment)
- Index (all assets)
- Accounting
- Tax
- FSA
- IMA Restrictions

Bar chart showing the percentage of barriers for each category.
The Australian Experience

2006 Exuberance

2007 Practicalities

2008 Ready, Get Set,

CRASH

2009 ?
Other Observations

“Catch 22”

Tertiary Education

Trust Confidence
A question for discussion

In the current Economic Climate does anyone think that there is a role for Property Derivatives this year in their portfolio or investment strategies?

Futures Curves.
Exploiting inadequate knowledge
Thank you for your time
Example of recent CD deal
... Prudential & British Land

<table>
<thead>
<tr>
<th>Buyer</th>
<th>Agent</th>
<th>Seller</th>
</tr>
</thead>
<tbody>
<tr>
<td>The British Land Company plc</td>
<td>Pay IPD All Property Index</td>
<td>Euro Hypo &amp; Deutsche Bank</td>
</tr>
<tr>
<td>£20m</td>
<td>Pay Interest Rate (LIBOR + Premium)</td>
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- Maturity of 3 years with annual settlement
- The agent charges a small fee on the notional value of the contract
The UK experience
... A potted history

- Early 1980s – era of PINCs, SPOTs & SAPCOs
- Since the 1990s – four attempts to establish an index based derivatives market based on IPD indices
  - London FOX 1991 x
  - Property Index Forwards (PIFs) 1994 +
  - Real Estate Index Markets (REIMs) 1998 +
  - Property Index Certificates (PICs) 1999 +
- Other attempts
  - Abbey National plc residential derivative based on Halifax residential price index