From Rents to Revenues: Can Property Become a Service Industry?

An investigation of the valuation implications of the generation of non-rental income streams by property owners

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Executive summary

The subject matter

The potential for property owners to take advantage of their asset and tenant base to generate further non-rental income streams is attracting growing interest. This research report outlines the results of an investigation of the implications for valuation practice of this emerging trend. The first section outlines the changing financial and market context in which these developments are occurring and examines the main drivers facilitating this shift by landlords. This is followed by an assessment of the areas where there is potential for owners to generate additional revenue through the provision of services. Potential structures and impediments to the growth of this sector are also assessed. The penultimate section of the report focuses on the consequences for valuation practice concentrating, in particular, on problems of attributing value where a space-service blend is being provided.

Methodology

The report's analysis is based upon a critical review of the main issues derived a literature review and interviews with key market actors. Two separate categories of property professional have been interviewed. One set of interviews was with representatives of institutional investors and major property companies. Typically interviewees were involved in asset management at the strategic level. These interviews focussed on the strategy of their respective organisations towards the provision of additional services and the areas where they perceived there to be opportunities. The second group of interviews was with the senior valuers of major surveying practices. These discussions focused on the experience of valuers in dealing with these types of income streams and their views on the implications for valuation practice.

Why is this change occurring and what does it involve?

The report argues that the last decade has seen a fundamental shift in the ways that many occupiers and investors regard property assets. Advisers, owners and occupiers are increasingly financially aware and innovative. The report focuses on the growing trend for occupiers to outsource property support services and seek flexibility in occupation driven by the interrelated forces of new technology, globalization and increased competition. It is illustrative that two of the most significant developments in the property sector – the growth of corporate PFI-type models and serviced office provision have at their core the outsourcing of property and other support services.

Consequently, a number of major landlords have argued that structural shifts in the organisation of production provide an opportunity to transform the nature of their business relationships with tenants. In particular, there is a perception amongst some owners that investment performance can be improved by providing a range of services in addition to space.

In the UK mainstream landlords have whenever practicable attempted to transfer to the tenant the costs and responsibilities associated the operation and maintenance of their assets. The tenant base has not been viewed as a business opportunity and landlords have not felt sufficient pressure to explore the economies of scope associated with the ownership of portfolios of leased property assets. This is despite competitive advantages produced by privileged knowledge of and access to their buildings and their tenants. This traditional remote style of management is changing due to pressures to improve investment performance and the enabling power of internet-centred technology.

Does it raise new strategic issues?

The types of strategic decision raised by the opportunity to provide services to tenants are by no means specific to the property sector. The micro-economics and business management literature devoted to the theory of the firm contains an enormous body of empirical and theoretical analysis related to optimisation of product range. The concepts and framework within these disciplines are extremely relevant to this topic. The possibility of property owners to develop new products can be analysed as a form of forward and backward vertical integration. Ironically, it is vertical disintegration within some business sectors that is providing opportunities for vertical integration in the property sector. Currently the trend in the property sector seems to be towards 'quasi-integration'. This refers to the range of alternatives that firms have between integration and disintegration to enter, for example, into partnerships and alliances. Indeed, arguably the viability of the provision of additional services should be assessed in terms of whether they are *complementary* products and services.

What are the potential additional revenue streams?

The report suggests that it is important to be realistic about the main activities in which landlords are likely to become involved and to avoid becoming distracted by hype often associated with innovative ideas. New business opportunities are likely to be associated with the provision of property-related services, new technology or infrastructure and the growth of e-procurement. The main method of market entry is likely to be through partnership with third party providers. The main areas identified here are facilities management, relocation and fit-out services, procurement of some non-property goods and services, e-procurement capabilities and broadband. The widespread expansion of landlords into provision of back-office functions, financial services, human resource management and other mainstream business support services is difficult to envisage. Where portfolios were owned by joint ventures, it was pointed out that the party responsible for the management of the portfolio could gain returns from fees generated for fund and asset management, performance-related bonuses and rewards from implementing funding and development transactions. Further, it is clear that owners who are developing businesses focussed on the provision of additional services envisage that the services will be offered to other occupiers and not just tenants. Revenue opportunities are not limited to the property owned by the landlord.

In the retail sector, large shopping centres seem to offer a whole range of opportunities. In addition to the potential for income generation from local area networks, more sophisticated exploitation of advertising sites, data acquisition, virtual malls; shopping centre owners also have the potential to contribute to their tenants business performance. The installation of broadband and development of replenishment centres can generate new revenue streams by improving tenants' logistics management, reducing (shopping centre) storage space and offering improved communications.

Will it be widely embraced?

It is concluded that the speed and extent of any change is likely to be unsystematic. Motivations to enter the market are revealing. For a minority of owners, the provision of services is perceived as a method of developing new revenue streams whilst enhancing the core property business. Whilst, for a significant proportion of major institutions, the motivation is essentially defensive. The aim is to protect investment values by making sure that their market offering is competitive.

This latter motivation does not indicate a confidence that there are large pools of untapped revenues that landlords have to-date neglected. Nevertheless it is certainly perceived that occupiers will increasingly demand additional services and that landlords who can meet this demand will at minimum protect and possibly enhance portfolio values. The extent of adoption depends partly on the ability and enthusiasm of property owners to enter these potential markets. Given that many institutional investors deliberately acquire investments that minimise management input, it is difficult to envisage rapid change from this source. It is likely that any change will be lead by the quoted sector which has been under pressure to improve performance and is itself quite diverse.

For individual buildings the viability of services provision is influenced by the level of demand, nature of service and proximity to other assets. The level of demand will, in turn, be influenced by the tenant mix. Large new, multi-let buildings with a range of relatively dynamic, small and medium-sized enterprises seem to offer the most potential for growth.

What are the main barriers to change?

There are a number of significant barriers to the expansion of the sector. In the long term, there are two key issues

(i) Is the provision of services a core competency? There is a perception amongst some property owners that diversification into the provision of services distracts management from its core tasks and can adversely affect performance in other areas.

(ii) Are the services complementary? There is no consensus that the additional services are complementary in the economic sense. There is scepticism that property owners have the necessary skills and infrastructure to compete on price and quality with specialist providers of goods and services.

The answers to these questions will vary from service to service and will in turn influence the degree of involvement by the property owner in delivery. In the short-medium term, there are a number of additional issues.

(iii) Asset and fund managers feel pressure to minimise ‘headcount’ and costs.

(iv) Current remuneration structures for mandated fund managers provide limited incentives to develop new revenue streams

(v) There are potential conflicts of interest issues for outsourced asset managers who involve themselves in the provision of services to tenants.

(vi) For the existing portfolio, there is a perception that there are significant costs for occupiers and owners associated with the disruption of existing procurement and management models. Market entry is likely to be easier where tenants are in the process of taking new space.

What are the likely business structures?

Whilst business models are embryonic and subject to adaptation, where landlords enter the support services industry it is unlikely that they will typically act as direct providers of services. Rather for many services they will tend to leverage their existing relationship and reputation to act as intermediaries, quality guarantors and risk sharers. It seems clear that some landlords intend to become the hub of a network of service providers to their business tenants.

Although it is emphasised that any shift in the nature of the landlord and tenant relationship is embryonic, the report suggests that there are two main approaches to the provision of services. The issue is whether the landlord charges directly for a service or wishes to receive returns from service provision through the benefits of an improved property offering. These benefits may include higher rental incomes and improved customer/tenant satisfaction. This distinction was described in terms of a choice between 'skimming' charges for services against providing 'good value' to the tenant. In reality the landlord has a wide range of options relating to the content of the 'bundles' of space-service blends that they offer. Whilst individual services will have different optimal patterns of provision and charging, the level of trade-off between 'charging' through rent and revenues will vary with property owner.

What do valuation precedents tell us?

Previous experience of the valuation of over-rented properties, lease inducements and abnormal rent review periods has illustrated how market shifts tend to be followed by confusion surrounding and new developments in valuation methodology. Typically, as conventional valuation methods are shown to be unable to reflect accurately the financial implications of market change, problems of pricing efficiency have emerged. Currently, although (and because) the relative size of the sums involved are often very small, valuers tend to adopt crude and simplistic models to value turnover rents, service charge surpluses and additional non-rental income.

How might this change affect information flows in the market?

There is potential for change in the nature of rent due to bundling of property and services. Conventionally in the UK rent has represented payment for the right to occupy a property for a specified time period. However, where landlords start to provide services in addition to property and introduce 'bundled' charging structures, the distinction between revenue from rent and charges for services becomes less clear. This is heightened where landlords explicitly introduce services to improve rental returns rather than to generate separate revenue streams directly. Where landlords 'bundle' the provision of services with flexibility of exit by providing break clauses or short leases, the difficulty of identifying the value of associated services becomes even more complicated.

Valuers may find the task of estimating the underlying rental payment for property difficult in the absence of 'trading' in a standard lease structure. This is the crux of the problem. Comparison approaches rely on some similarity in transactions to provide a benchmark against which deviations can be compared. The benchmark of a 15 year full repairing and insuring lease with five yearly upwardly only rent reviews is unlikely to disappear in the short term. However, in the medium to long-term it is possible to envisage a situation where landlords offer a whole host of occupational solutions to their tenants. Where diversity dominates, the *traditional* income methodologies will become obsolete. However, this is a point for the long term rather than the short-term and past experience suggests that valuation processes adapt to market changes.

How will valuation methodology be affected?

A key conclusion is that where income profiles become less predictable and more heterogeneous, valuers tend to adopt explicit discounted cash flow techniques for the purposes of estimating market price. The valuation of shopping centres, hotels and serviced offices are revealing precedents of this trend. The use of discounted cash flow techniques both to estimate individual and market *worth* and to estimate market *price* provides scope for confusion in terms of the different information requirements. In the US and Canada where, discounted cash flow techniques are used for both functions, guidance is very explicit on the need for information on market expectations to provide the basis for estimates of market price.

Transferability of income streams is crucial

Transferability and liquidity of additional income streams is a key issue. Although investors can 'unbundle' the different income streams from property assets, it is apparent that certain revenue streams are inextricably linked to ownership of the property. The key distinction is whether income is appended to the property. Revenues from (and contracts associated with) the provision of services where there is a physical connection with the building such as broadband, utilities, car-parking and advertising are generally transferable with the property to a new owner. In turn, other revenue streams generated from the tenant base such as payments and contracts for FM services or fit-out/relocation are unlikely to be portable in the same way.

What are the implications for valuation in practice?

A number of salient points came out of the discussions with valuers.

(i) There is a perception that there may be a 'skills gap' and that not all valuers are comfortable with business valuation techniques.

(ii) Understanding the risk-return characteristics of non-rental income streams in terms of tranferability, growth, sustainability and risk will become increasingly important as the relative size of these income streams grows.

(iii) Understanding the interdependencies between rental income and the level and quality of the provision of additional services will be a key issue in the long term.

(iv) More obviously, professional guidance will need to reflect the changing nature of the valuation process implied by this analysis.

1.0 Introduction

In business environments where many organisations are seeking to outsource non-core functions; self-provision of a range of property and business support services is often sub-optimal for many firms. This has created market opportunities for some providers. In the UK, the majority of large landlords have attempted to transfer to the tenant the costs and responsibilities associated the operation and maintenance of their assets. The tenant base has not been viewed as a business opportunity and landlords have not felt pressure to explore the economies of scope associated with the ownership of portfolios of leased property assets. This is despite obvious competitive advantages produced by privileged knowledge of and access to their buildings and their tenants. The traditional remote style of management is changing due to pressures to improve investment performance.

The REIT Modernization Act provides an indication of the direction of change in the US. REITs have now been permitted to set up Taxable REIT Subsidiaries in order to overcome the restrictions on the ancillary businesses that REITs could be engaged in. This reflected a growing recognition that the tenant base provides a 'captive audience' who may be prepared to buy a range of services enabling REITs to improve the income return. In the UK, a number of landlords are now exploring the potential to enhance the value of the properties through the provision of services to their tenant base. Potential areas include the provision of; facilities management (FM) and property services, procurement of non-property goods and services, back office functions and broadband *inter alia*.

This research report outlines the results of an investigation of the implications for valuation practice of the generation of non-rental revenue streams by property owners. The remainder of the report is organised as follows. The first part outlines the changing financial and market context in which these developments are occurring and examines the main drivers facilitating this shift by landlords. This is followed by an assessment of the areas where there is potential for owners to generate additional revenue through the provision of services. The third part of the report focuses on the consequences for valuation practice concentrating, in particular, on problems of attributing value where a space-service blend is being provided.

1.1 Methodology

The scarcity of secondary data sources on the valuation of property-related services makes quantitative research difficult. This factor, allied to the exploratory nature of the proposal, suggested that the optimal method of achieving the aims and objectives outlined lay in a qualitative research approach. In addition, this permits a more creative, adaptive and flexible style of research. It also reflects a preconception that knowledge of the research issues is currently *situated* with professionals and can be best accessed by personal interview or ‘close dialogue’ (Clark, 1997).

The report consists of a critical review of the issues outlined above, a literature review and interviews with key market actors. Two separate categories of property professional have been interviewed. One set of interviews was with the representatives of institutional and major property companies. Typically interviewees were involved in asset management at the strategic level. These interviews focused on the strategy of their respective organisations towards the provision of additional services and the areas where they perceived there to be opportunities. The second group of interviews was with the senior valuers of major surveying practices. A list of all interviewees is provided in Appendix 1. A semi-structured interview approach was considered appropriate since the inherently restricted nature of a questionnaire survey limits the scope for in-depth discussion of opinions, experiences and attitudes. However, it is stressed that the interview structure was generally flexible to reflect the particular circumstances, experience and approach of each interviewee. Interview structures also allowed insights from previous interviews to be addressed in later discussions.

In total 15 interviews were carried out. The size of sample reflects prior perceptions of adequacy in this context. No formal methodology was used to identify potential interviewees. The interviewees either had an acknowledged reputation in the subject area reflected in the literature, corporate activities and/or recommendation. The sample was both self-selecting and ‘convenient’ in that interviewees were identified either from the researcher’s knowledge and experience or as having a particular remit in the areas discussed.

2.0 The Market Context

2.1 Introduction

The increased interest from property owners in the potential to add value to their portfolios by providing services is one of a number of market innovations in the property sector in the 1990s. Although sometimes caricatured as lethargic, over the last decade the property sector has witnessed the emergence of new types of occupational, financing and investment products. The section outlines the main areas where innovation had occurred.

2.2 New developments in corporate finance

In the area of corporate finance, the 1990s have seen an acceleration in the application of innovative financial techniques to the property market. The property industry has increasingly adapted products and techniques from the capital markets. In addition to the emergence of the corporate outsourcing sector, Lizieri *et al* (2001) identify a range of innovations including;

- increased use of asset and mortgage backed securitisation,
- the development of property derivative products,
- new forms of sale and leaseback and off-balance sheet structures and
- growth of limited partnerships and special purpose (offshore) vehicles.

Lizieri et al conclude that

> "..a breed of finance-led property professionals have emerged in the UK, less influenced by the "all-risk yield" than a concern for total returns and cash-flow-generated performance" (Lizieri *et al*, 2001, p. 53)

Interestingly, they identify valuers as stifling innovation arguing that the use of traditional valuation methods is problematic for the pricing of differing cash flow patterns. Whilst these transactions often involve large single assets and portfolios of properties, at the same time there is a growing recognition that individual property assets can be unbundled.

2.3 *Unbundling the asset*

There is an increasing appreciation amongst investors of the complexity of commercial property as an asset class, the optionality inherent in commercial property investments and the potential to exploit these characteristics to improve returns. The single property asset consists of a package of diverse financial interests each of which has different risk-return characteristics. Importantly, each can also be traded separately from the ownership of the property asset. Innovative investors such as Rotch Property Group are reported to have 'stripped out' the different elements of the income stream. Investors have achieved arbitrage gains by securitising the fixed income components of properties let on long leases. They can then either retain or sell the rights to the residual value and/or future increases in rent at rent reviews. In turn, innovative insurance products have also emerged in the commercial lending sector which enable borrowers to insure against tenant default and low residual values.

It is interesting to note that this market change has had implications for valuation. Motivated by the 'deconstruction' the property asset, innovative approaches to the valuation of commercial property assets pioneered by one actuarial firm (William M Mercer Ltd) in particular have been used by Rotch Property Group to appraise their assets. However, the so-called 'actuarial' approach is still at an embryonic stage and is still not fully in the public domain.

2.4 *Changing lease structures*

Closely linked to the issue of service provision is the increasing demand for flexibility from businesses. Driven and facilitated by the interrelated forces of globalisation, technological innovation and increased competition, businesses have needed to be more agile in their production of goods and services. For instance, Gibson and Lizieri (1999) have drawn an analogy between the concepts of core and peripheral labour forces and property assets. They argue that the same drivers leading businesses to require more flexibility in their labour force are also producing demand for flexibility in their property portfolios. Whilst initially forced by market pressures to introduce flexi-leases, it is clear that some property owners have now identified the opportunity provided by the demand for flexibility and have attempted to develop property products to fulfil this demand. The outcome of this market and structural shift is a much more diverse pattern of lease lengths within the UK. The main change has been a decrease in effective length of lease in all sectors and the disappearance of a standard market lease length (see Crosby *et al*, 2000 for a definitive discussion of changes in lease structures). Further, in the corporate sector, some large companies have or are in the process of disposing of their property assets completely and occupying through service contracts rather than leases.

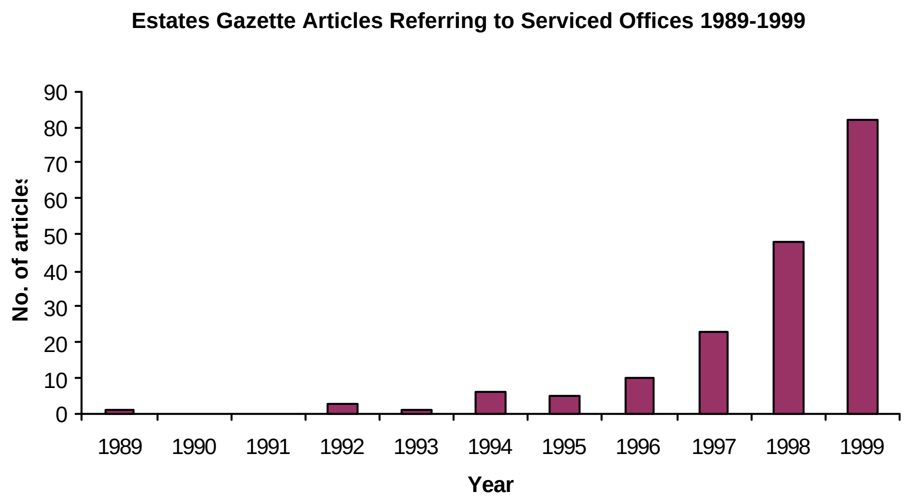
2.5 *The emergence of corporate property outsourcing*

A key development in the property sector in the 1990's has been intermediation as organisations have emerged which have 're-engineered' the landlord and tenant relationship. In response to corporate and public sector demand to outsource the provision of property and associated services and to release the value of their assets, companies such as Mapely, MWB and Trillium provide accommodation and FM services to corporate and public sector occupiers. Typically in return for a capital payment, the organisation gives up ownership of their portfolio and enters into a long-term contract to occupy space and to receive a range of services. There is unitary charging for the space and services. Whilst this PFI-type of agreement has been restricted to large organisations, another service that experienced rapid expansion in the 1990's has been serviced offices. In this sector the market has been small and medium sized enterprises and short term corporate project teams and, arguably, the emphasis has been more on services than the offices.

2.6 *The expansion of the serviced office sector*

Although the serviced office concept has been established in the UK for a number of decades, until the late 1980s the sector was characterised by fragmentation and diversity of ownership and nature of operation. There is a lack of data on the expansion of the sector. The first mention in the Estates Gazette of serviced offices is in 1989. In the absence of detailed data on sector growth, a simple citations approach is used below to illustrate the emergence of the sector in the property mainstream in the mid-1990s. References in the Estates Gazette to serviced offices are presented as a proxy for sector growth and development.

Figure 1



Specialist serviced office providers, such as Regus, HQ and MWB offer a combination of flexibility and services to their occupiers and have been the main suppliers. Typically, they provide a full range of business support to their occupiers in terms of facilities management, equipment, IT, catering, secretarial/reception etc in addition to flexibility of exit from operational properties.

At present, serviced offices are mainly occupied on the basis of freehold ownership and traditional leases. Some serviced operators have been entering into equity share arrangements with landlords. In this type of lease structure, the operator typically pays a proportion of the open market rental value (50-80%) plus a rent linked directly to the profitability of the business centre. This arrangement is similar to a base plus turnover rent arrangements found in the retail sector. Although a less common model, Tower 42 (partially a serviced office) is operated on the basis of a management contract to the serviced office operator. As the institutions enter this market, an alternative approach has been for institutions to form joint ventures with serviced office providers with the revenue generated by the joint venture being shared between the provider and the institution. A good example is the recent joint venture between Stonemartin and Morley.

It is illustrative that the valuation of serviced offices has been the topic of some controversy. Research suggest that the untried nature of the business models, the lack of track record of the tenants and concerns about premature depreciation created a stigma effect (Crosby *et al*, 2000). Whilst this has gradually diminished, there remains a debate about methodology and the relative contributions of property value and business value to valuing the interests of the serviced office provider. A key issue is that there are a number of revenue streams generated by a serviced office provider in the building.

The valuation problem has concerned the basis and method of valuation. The fundamental conclusion of the research was that serviced offices contained a business and a property component which could be valued separately (see Crosby *et al*, 2000 for a fuller discussion). This debate has obvious implications for any analysis of the valuation implications of landlords shifting toward a service provider model. However, before going on to assess the valuation issues, the drivers and nature of the trend are discussed.

3.0 Why Now?

3.1 Introduction

It is clear from the discussion above that the procurement and supply of property has fundamentally changed in the last decade. The growing interest in landlords in this providing additional services represents continuing evolution in the sector. Below, the main drivers and facilitators of this shift are assessed.

3.2 A Technology Driven Evolution

The advances in telematics over the last two decades are well-documented. Internet-centred technology, in particular, has expanded the range of options that businesses have to structure their production, procurement, distribution, marketing and retailing functions. For most business sectors, there is a consensus that Internet-centred technology enables;

- better customer service through online access to provider and client systems,
- expanded market reach,
- lower transaction costs due to the automation,
- increased speed to market,
- lower barriers to entry,
- improved information provision,
- improved transparency and
- increased competition from potential suppliers.

A recent publication by the Dti (2001) argues that the key consequences of these factors are likely to be

(i) An increase in the importance of brands and relationships as 'signals' of quality with a consequent ability to leverage brand presence and reputation from one market to another at reduced entry cost.

(ii) A reduced role for some intermediaries and the creation of new intermediaries such as 'best buy' sites, quality guarantors and information brokers.

(iii) More amorphous market and company structures with a continuation of the trend away from vertically integrated companies towards networks.

It will become apparent that these three outcomes are central to this research and that they have the potential to transform the role of property managers.

A major impact of technological innovation is that it has enabled businesses to re-structure the supply chain in order to improve productivity. This re-structuring provides opportunities for property owners to enhance their contribution to the supply chain and Internet-centred technology has facilitated the market entry of property owners. Essentially, the technology provides property owners with a relatively low cost means of extending their relationship with their tenants. Although it could be reasonably argued that costs of communication with clients have not been a major barrier in the past, it is interesting to note that the most advanced providers of additional services offer a largely web-based method of procurement.

3.3 Outsourcing

Probably the most significant change in the organisation of production of goods and services over the last decade has been the expansion of outsourcing. The 'ideology' of core competency focus has led businesses to critically examine their production organisation in order to concentrate on sectors where they can be pre-eminent and to outsource functions in which they do not have competitive advantage. The key advantages of outsourcing are regarded as being; reduced capital investment and operating costs, access to 'best in class' providers, shared risks and ability to focus on core functions (see Moore, 2001, and Kistler, 2001). Internet-centred technology has reduced the transaction costs associated with outsourcing such as costs of search, contracting and monitoring. A direct consequence has been rapid expansion in the demand for a whole range of business support services such as IT support, facilities management and back office functions.

Outsourcing does not only provide opportunities for property owners at the business-level, it is clear that potential business opportunities are emerging at the level of the individual. Affluent office workers may wish to 'outsource' a number of their domestic tasks in order to be able to devote more time to professional activities. A consequence is that property owners *inter alia* have identified concierge services as a potential source of revenue in buildings occupied by 'money rich, time poor' employees. The recent arrangement between Inviego and UBS highlights the potential of this area for income generation.

3.3 Bundling

A paradox of business evolution in the 1990's has been the growth of bundling alongside the spread of outsourcing. Bundling refers to "the practice of marketing two or more products and/or services in a single 'package' for a special price" (Guiltinan, 1987, p. 74). It is found practically everywhere in the consumer sector and is increasingly common in the commercial sector. For instance, it has been observed that as companies such as Lucent, GE and General Motors have become increasingly involved in providing finance to such an extent that manufacturing may be becoming a loss-leader in the profit chain. For clients the main benefits of bundling are reduced search costs and lower transaction costs, whilst providers gain additional income streams and also gain from lower transaction costs.

For bundling to occur in the commercial property sector, an obvious prerequisite is that property owners have a range of products and services to bundle. This has rarely been the case, as owners have tended to offer a uniform commodity – a standard unit of space let on standard terms at a single price. The most obvious example where it does occur is in the serviced office sector where occupiers are typically offered a 'package' which includes flexibility of occupation, utilities, some business support services and equipment for a single price whilst having the option to source other services (catering, IT support etc). If we regard the 20 year FRI lease and the serviced office sector as two extremes, we can observe that some property investors attempting to develop products that blend the two. A good example is Arlington's Total Workspace Solution which offers a terms of occupation from three to five years fully inclusive of (some) utilities with the option to access FM and a range of other services. Consistent with their acquisition of Trillium, Land Securities are exploring the potential of introducing unitary charging for a 'bundle' of property and additional services.

3.4 New Products

The Dti research discussed above highlighted the potential of the Internet to allow intermediaries to occur offering existing products and services through new channels. The emergence of new technology is proving disruptive to established, often inherently passive, models of property management. As well as facilitating the development of new relationships between property owners and occupiers, the rapid development of Internet related technology may force property owners to respond to demand for connectivity. For instance, the growing broadband sector provides an example of how property owners have been forced to consider their traditional relationship with their tenants. The growth of Internet-centred technology has enabled the provision of a whole range of Web-based services leading a number of property companies to develop specialist software products. There is a general consensus that landlords who wish to keep their buildings competitive should consider growing business demand for services and flexibility.

3.5 Pressures to innovate

The performance of the quoted property sector has been perceived as poor. Currently, property companies in the UK have historically large discounts to Net Asset Values. Criticism has focussed on the high management costs associated with the sector relative to direct investors and the lack of added value. Indeed, they have been labelled 'value destroyers'. John Plender is in tune with a body of opinion when he states that

> "Quoted companies are much more risky than direct property investment, yet they have offered historical returns no higher than the ungeared raw material of land, bricks and mortar. The conclusion must be that, on average, corporate investors in property have been lousy financial managers." (Plender, 2001, p. 23)

Although recent performance has been relatively good, there is still a perception that property equities remains a relatively safe haven in a volatile market rather than a long term investment. For instance, it is revealing that service office providers wish to be listed in the support services rather than the real estate sector. This shift towards services the quoted sector has been partly motivated by an attempt to improve the market's perception of the quoted sector by attempting to enter the technology and business support service sectors. Although market 'fashions' have now changed, the opportunities still exist.

3.6 A service industry?

One interviewee argued that the property industry is the last major economic sector to embrace the importance of customer relations and quality of service. It was suggested that the long term and essentially asymmetrical nature of lease contracts has provided little incentive for owners to be concerned about quality. Further, the shift towards more flexible leases, the growth of corporate property outsourcing and serviced offices create a context in which quality of service and customer satisfaction are increasingly relevant to investment performance. In the fund management sector, it has already been noted that a number of interviewees cited the need to maintain and improve the attractiveness of their product as an incentive to provide services. In the context of market where tenants were increasingly wishing to outsource many services, there was recognition that landlords who were able to offer an attractive package of services as well as space would obtain a competitive advantage and be in a position to retain existing and attract new tenants. This, in turn, would lead to fewer voids and improved income return and security

In summary, it is clear that the supply of services by landlords is being facilitated by the emergence of web-based technologies and driven by increased pressures on landlords to be innovative and customer focussed. The demand is being created by the trend for businesses to outsource non-core functions. As a result, landlords are beginning to 'bundle' space and services provision to tenants.

4.0 Identifying The New Revenue Opportunities

4.1 Introduction

This section discusses the potential areas where property owners may be able to develop new business opportunities. Currently, a relatively small number of property investors are pioneering the introduction of the services and products discussed. Consequently, many of the models are embryonic and still evolving. However, it seems clear that opportunities exist in both the retail and commercial sectors and that the new revenue streams are in both landlord-to-business (L2B) services and landlord-to-consumer (L2C) services.

4.2 Facilities Management

Given that owners typically have a 'head start' in terms of detailed knowledge concerning their buildings and the associated M&E services, there has been an obvious potential opportunity to market maintenance services to occupiers. Owners have the potential to offer a range of property services that occupiers otherwise have to procure elsewhere. It should also be borne in mind that many property owners already provide varying levels of FM services in shopping centres and other multi-let buildings.
The main areas are

- Landscaping
- Security
- External fabric maintenance and cleaning
- Internal fabric maintenance and cleaning
- Waste management
- Mechanical and electrical maintenance

Currently, very few mainstream commercial landlords offer comprehensive FM services.

In terms of their return potential, the characteristics of the income stream from an FM contract will depend on both the charging structure, the predictability of expected costs and the term of the contract. Where property owners provide FM services, it may be structured as a separate 'spin-off' company. For instance, British Land provide FM services in the City through Broadgate Estates Plc. This was originally set up to provide FM services to tenants of British Land at Broadgate. However, the company has subsequently won FM tenders for other buildings close to Broadgate and expanded accordingly. However, it is also clear from interviews that landlords regard FM has a low margin business with substantial cost pressures. Whilst it is recognised that they may need the capability to offer the service, there is limited enthusiasm about its potential to generate significant revenue streams.

4.3 Relocation and Fitting Out

The one-off event of moving into the premises and rendering them suitable for operational purposes involves substantial outlay by the tenant. Property owners are well placed to exploit the business opportunities concerning any relocation and occupation due to their existing relationship with the tenant, the associated information of their plans and their knowledge of the building itself. Below, in order to illustrate the potential of this sector, the range of services offered by Arlington as part of their workspace support are outlined

- Inventory and layout
- Project management of move
- Space audit
- Services integration and compliance
- Interior design and space planning
- Building appraisal
- Service and system design
- Furniture selection
- Insurance approvals and liaison
- Fit-out, cabling, telecoms and services installation
- Finance, lease purchase options
- Approvals and consents
- Competitive tendering
- Fit-out management
- Commissioning and testing
- After care
- Relocation and moving
- Risk assessment

The income profile will be closely related to the relocation decision. For the single, property, it will be transaction driven and lumpy. However, for large landlords, a steady stream of business from tenant relocations should reduce the volatility of the income. Alternatively, a number of interviewees pointed out that they commonly arranged fit out for tenants with a number of payback options including 'rentalising' the capital cost. In addition, although unexplored, there is potential to partner with existing relocation services providers.

4.4 Procurement of non-property goods and services

Procurement services provide another opportunity for property owners with scale often cited as the critical variable. Many SMEs and relatively autonomous business units of corporations are unlikely to possess either the resources and/or skills to optimise the procurement process or the market power to obtain bulk discounts. Aggregation is the key to volume discounts. Although any landlord can attempt to aggregate the buying power of their tenants, large landlords, in particular, have the potential to use their purchasing power to achieve discounts and then to exploit potential arbitrage opportunities in procurement. Using Preferred Provider models or bulk purchase, they can obtain a range of business goods and services at discounted prices for their tenants whilst obtaining a margin on the revenue generated.

A number of landlords interviewed stated that they currently procured utilities at discounted levels for their tenants in multi-let buildings. However, the full discount was generally passed on to the occupier. One respondent noted that the consequent lower occupancy costs may be reflected in a higher rent or more marketable building. One of the benefits of Rotch's Interactive Property Management product is that clients are offered reduced cost electricity in addition to a range of other services. A number of business park operators are reviewing the viability of generating their own sources of electricity to sell to tenants. An example of this provision, currently exceptional, is Slough Heat and Power (a part of Slough Trading Estate) which provides electricity to tenants and the National Grid.

4.5 E-Procurement

E-procurement, in particular, has been identified as a potential growth area. The potential of the Internet to revolutionise business-to-business transactions has been well-documented. For the procurement process, it essentially permits increased automation of the traditional procurement functions. The main benefits have been identified as:

- reduced costs of processing transactions, particularly due to the elimination/reduction of paper documentation;

- reduced costs of items due above, bulk purchasing and elimination of intermediaries such as wholesalers and distributors; and

- improved organisational control of procurement process and reduced costs of data collection and monitoring.

In turn, e-procurement was seen to have the potential to generate three sources of revenue for landlords through

- advertising[1],
- commissions and
- arbitrage

A number of landlords and property consultancies in the UK have been pioneering the introduction of online procurement facilities through Intranets. Driven initially by an attempt to create 'virtual communities' in business parks, sites are being upgraded to allow for a wider range of services to be offered. These fall into two main areas

- Landlord-to-consumer – information, online shopping, retail services (eg. dry cleaning)

- Landlord-to-business – procurement of goods and services

Reported operators of such Intranets in the UK are Arlington, Rouse Kent, MEPC, British Land and Jones Lang Lasalle. The latter is quite interesting since, whilst the main innovators have been business park operators, this is the first reported introduction of an e-procurement facility in a UK city centre multi-let development. Other more specialised systems are emerging targeted at the property or facilities manager. For instance, Chesterton have introduced an e-procurement product which focuses on facilities management services.

Intermediation can produce a win-win outcome for both landlord and tenant. It is not difficult to envisage the list of services where this may be possible – business travel, recruitment, professional services, database management, graphic design, equipment hire, financing etc. The potential opportunity seems to lie in generic business support services rather than in sector-specific goods and services. Outside of utilities, a likely

[1] To date, web site advertising has generated disappointing revenue streams and seems unlikely to be a major source of income in this context.

model is a joint venture or partnership with specialist procurement company or a specialist provider in single area (e.g. IT).

However, interviews suggested a degree of scepticism among a number of landlords concerning the revenue generating potential of intermediation and e-procurement. A number of questions can be posed. Given the convenience of the Internet as a procurement tool, it was questioned whether landlords were likely to have a competitive advantage over established intermediaries. Is it reasonable to expect that established intermediaries will permit market entrants to capture a proportion of their margin without a reaction? To be successful, landlords would need to be able to offer tenants a high quality service at lowest cost. It is likely that this would only be achievable in sectors where existing intermediaries were earning supernormal profits or business costs of search were high. Even where these conditions held, the product or service offered by the landlord would have to be amongst 'best in class'.

4.6 Back-office Functions

Competitive pressures to consolidate costs and focus on the core business have facilitated the emergence of a relatively new business sector specialising in outsourcing back office functions. Major corporations have been able to create 'spin-off' companies who both provide back office functions to both their 'parent' firm and other organisations. However, a key point is that typically the model has been for firms with established expertise and other infrastructure in a given sector to separate out the back office functions and create new businesses. There seem to have been relatively few 'from scratch' start-ups. This is particularly advanced in the banking and fund management sectors. In the US, a number of landlords have been attempting to exploit this market by offering back-office functions to tenants. It is likely that landlords will only be able to enter the market for outsourcing generic back office functions such as human resource administration, accounts, credit control, data processing and IT services - and only then with a suitable partner. In addition there is potential to use the access to the tenant to market new business support products. A good example is the joint venture between Deloitte and Touche, Flint House Limited and Land Securities which has developed specialist software for managing tax reporting requirements. Again for landlords the main market for such services and products seems to be with SMEs. In terms of a reality check, it is difficult to envisage a large expansion of this area. It is revealing that there are no reported examples of landlords providing back-offce functions in the UK.

4.7 Broadband

Recent research suggests that connectivity is becoming increasingly important to tenants (JLL, 2001). Currently a great deal of interest is being generated by the issue of communications infrastructure in commercial premises and its potential to create new sources of income and augment rental and capital values. The United States, in particular, saw dramatic growth riser companies (or building-centric local exchange companies – BLECs) during the period 1998-2000. As demand from the major corporations has matured, riser companies have been seeking to supply medium and small sized firms concentrated in multi-let, high rise buildings and industrial parks. Typically, these companies are going into partnership with landlords to install the infrastructure for high speed Internet access providing rapid data transfer, videophone and telephony. The riser business model is also predicated upon the capture of other incomes streams for the provision of additional IT services such as; support, ASP services, and e-commerce services.

Initially, this growth was driven in the UK by US broadband companies. However, the combination of falling equity markets, the 'dot.com bust' and slowing economic growth in the US has forced many of these providers to retrench into their core markets. However, UK commercial property owners have reacted to the emergence of this opportunity and a large consortium of them is currently partnering with HighSpeed Office to provide broadband technology to their buildings. Conflicting experiences of the potential of this sector were found at interviews. One major owner interviewed indicated that their research on potential demand from their tenants for this service had been extremely positive. However, this was contradicted by the experience of another large company who found that actual take-up was disappointing and considered that any consideration of the potential to generate revenues from additional IT services was premature.

The nature of the revenue stream that emerges depends on the provision model adopted. Each provision model basically differs on the allocation of initial investment and risk and reward between the service provider and the building owner. The descriptions of the provision models provided here draw on two presentations made by Bob Thompson of King Sturge and Brenna O'Roarty of JLL Research. Consequently, given a decreasing ability to raise new capital and the lack of experience in these areas in this market, it is no surprise to observe that the model developed the UK consortium is in line with a partnership provision model.

The main benefits of broadband installation for the landlord are improved infrastructure, more marketable premises and an additional income stream. Three main motivations for joining the consortium were proffered by one respondent. These were;

- to generate additional revenue from broadband usage,
- to generate additional rent from increased demand for a 'wired' building and
- to keep property portfolio competitive in the market for occupiers.

Landlords had considered the implications of broadband installation upon asset disposal. Essentially, landlord contracts with providers enabled the property owner to terminate the contract at asset disposal and assign to the new owner. It was considered that it was highly likely that new owners would continue existing arrangements in order to maintain the income stream and to avoid alienating the tenants using the service. It was generally considered unlikely that previous owners would retain the existing broadband arrangement since it would deter potential buyers and tend to reduce liquidity.

1	**Low cost provision model**
Initial Investment	By broadband company
Risk	Negligible
Control	Limited
Management input	Negligible
Main upside	Obtain 'wired' building at low cost
Main downside	Limited participation in revenue from high added value services
Source of return	% of gross spend on telecomms/data traffic
	Possible equity share in riser company

2	**Partnership provision model**
Initial Investment	By property owner
Risk	Often offset to service provider
Control	Enhanced
Management input	Greater but still mainly with service provider
Main upside	Obtain 'wired' building with associated advantages
	Ability to participate in additional revenue streams
Main downside	Up-front cost
Source of return	60-65% of gross spend on telecomms/data traffic
	Share of additional revenue streams
	Possible equity share in riser company

3	**Self provision model**
Initial Investment	By property owner
Owner input	Substantial
Risk	Needs to be offset
Control	Substantial
Management input	Substantial
Main upside	Control of quality of services
	Potential re-branding as innovative service provider
	Participation in high growth sector
Main downside	High capital investment
	Need to specialist staff and technology
	Outside core competency
Source of return	Revenue from both usage and additional services

Whilst the analysis presented above would suggest that partnership with broadband providers was a relatively obvious solution, an alternative view expressed during interviews was that ensuring tenant choice and access to best quality services was another key issue that needed to be addressed. The view was expressed that permitting a number of operators on a business park for instance ensured that tenants were not exposed to a single provider and could be offered a number of solutions to telecomms provision.

It is apparent that broadband provision will often generate revenue streams for the property owner. However, in the short term it may also affect other income streams from property assets. For instance one market participant suggested that

> "The market perception appears to be that new buildings which are provided with a fibre optic backbone will have a significant market advantage, be this in terms of either increased rents or perhaps a reduced rent-free period. However, our view is that, within two to three years, the provision of an appropriate backbone will become a requirement rather than a marketing advantage." (see Kavanagh and Jack, 2001, p. 127).

This suggests that the installation of broadband technology will also begin to affect the income profile separate from pure broadband revenues. This is due to the possibility that tenants pay not only for the provision of a service but pay additional rent for a building that provides access to this service.

4.8 Additional spin-offs

Where portfolios where owned by joint ventures, it was pointed out that the party responsible for the management of the portfolio could gain returns from three sources including

- income and capital returns provided to equity investors,
- profits generated by the provision of services to tenants and
- fees generated for fund and asset management, performance-related bonuses and rewards from implementing funding and development transactions.

Alternatively, one interviewee was currently in partnership with other organisations to develop a business which would advise on the generation of additional revenues and co-ordinate bulk purchase of goods and services through aggregation. In addition, one interviewee was able to point to examples in the US where a landlord offering telecommunications services to a major corporate was given the contract to provide these services for the whole company. On a less dramatic scale, it is clear that owners who are developing businesses focussed on the provision of additional services envisage that the services will be offered to other occupiers and not just tenants. Whatever the level or nature of expansion, it is clear that revenue opportunities are not limited to the property owned by the landlord.

4.9 Retail

The prime retail sector is largely divided between free-standing retail units and shopping centres. It is the latter which is the focus of this discussion since shopping centres, in particular, provide useful insights into the potentially changing roles of property managers and valuers. Besides being forced to provide a relatively full FM service, owners of shopping centres have always generated additional non-rental income streams linked to their asset. These include revenues from

- car parks,
- market stalls,
- advertising sites,
- ATMs,
- mobile telephony infrastructure and
- other concessions.

However, the emergence of Internet-centred technology has also created opportunities for owners to develop their relationships with both visitors to and tenants of shopping centres.

The customer base

A topic generating particular interest is the sheer size of the consumer base that uses shopping centres. For instance, the Annual Report of Land Securities states that

> "..there are in excess of 150 million visits each year to our various centres and we are currently pursuing a number of initiatives to generate additional income from companies keen to access the high levels of consumer visits" (Land Securities, 2001, p. 19)

Property companies interviewed are considering a number of ways to exploit the brand and consumer loyalty associated with regional and sub-regional shopping centres. These include

- virtual malls,
- improved advertising (video walls, plasma screens)
- loyalty cards,
- CCTV,
- endorsements
- data acquisition and,
- in-centre mobile phone marketing schemes and price searching facilities,

The tenant base

It was pointed out by interviewees with experience of shopping centre management that the tenant base presented retail-specific opportunities to generate additional revenues. A particular area was logistics management. A number of interviewees commented that inventory control by a large number of UK retailers was relatively undeveloped and that landlords could improve the supply chain. For instance, one interviewee noted that in one of their major regional shopping centres, a number of the retailers had acquired storage facilities in the vicinity for logistics purposes. Consequently, they are exploring the possibility of linking managed warehouses to regional and sub-regional shopping centres with potential to provide pre-retailing services and pick-up and drop-off services to consumers on behalf of retailers. The development of replenishment centres could enable retailers to improve their customer/sale conversion rates and reduce storage space (and increase sales space).

Further potential opportunities provided by broadband technology were identified including

- rapid credit authorisation for credit card purchases,
- Webcam facilities,

- training and recruitment,
- video-conferencing,
- EPOS,
- ASP services and
- Customer relationship management

Although it is emphasised that for the majority of examples highlighted the value currently lies in the option to provide rather than the actual provision of services, it is clear that additional non-rental revenues have been obtained from shopping centre developments for decades. Techniques for their valuation should provide insights into the implications for office users.

4.10 Scale plays or economies of horizontal integration

It has already been argued that the ability of landlords to aggregate the buying power of their tenants provides opportunities for owners of large portfolios to act as intermediaries between suppliers and their customers. It seems clear from the interviews and from anecdotal evidence that a number property companies perceive opportunities in the acquisition of large, often geographically dispersed, single use (and often single tenant) properties such as petrol filling stations and public houses. The control of such portfolios enables the owners to market their sites for providers of advertising, telecommunications infrastructure and ATMs. The key advantage is that their scale reduces the search and transaction costs of companies who require a number of locations over a wide geographical catchment area in addition to being nodal points. Although access to the often huge customer throughput lies with the retailer, there undoubted potential opportunities for the landlord. In addition, owners with critical geographical aggregation consisting of ownership of concentrations of assets in a relatively small location can also benefit from economies of scale in service provision relatively to owners who have to service a more geographically dispersed customer base. Grosvenor Estates provides a good example of a portfolio of occupiers with a single owner concentrated in the West End of London.

5.0 Prospective structures and potential impediments

5.1 Introduction

The discussion above argued that the changing business and technological environment has provided opportunities for new intermediaries, quality guarantors and risk-sharers. It is these types of roles that landlords seem to be developing. However, it is also apparent that there is a wide range of potential revenue opportunities with diverse risk-return characteristics. Landlords also have a number of decisions regarding the structure of the service operation. The model selected will affect the income profile generated and the linkage with the property asset. This section discusses the types of options open to landlords and identifies the barriers to landlords from developing this market.

5.2 Vertical integration?

Whilst all of the research interviews focussed on the opportunities and potential of the property sector, it is clear that the many of the problems raised or implied are neither new nor restricted to the property sector. The micro-economics and business management literature devoted to the theory of the firm contains an enormous quantity of empirical and theoretical analysis related to optimisation of product range. The concepts and framework within these disciplines are extremely relevant to this topic and many of the points raised in the interviews have parallels in the business economics literature.

The possibility of property owners to develop new products can be analysed as a form of forward and backward vertical integration[2]. Vertical integration typically involves the production of distinct goods and services within the single firm. The outsourcing discussion in Section 3 highlights the fact that vertical integration has been somewhat out of fashion with clear trends towards vertical *disintegration* in many business sectors. Ironically, disintegration is some sectors is providing opportunities for integration in the property sector. Currently the trend in the property sector seems to be towards, what Michael Porter (1980) labels, 'quasi-integration'. This refers to the range of alternatives that firms have between integration and disintegration to enter, for example, into partnerships and alliances.

[2] For instance, entry to the market for FM and fit-out services can be viewed as forward vertical integration whilst for relocation services it can be seen as a form of backward integration

The potential benefits of the product range diversification often associated with vertical integration are echoed in the literature on bundling and procurement strategies. The debate concerning the merits of vertical integration overlaps in many instances with the whole topic of outsourcing and focus on core competencies. Customers benefit from the logistical efficiencies of 'one-stop shopping' whilst the supplier benefit from customer retention, control over the quality of the product and potential new customers (see Kline, 2001). Vertical integration is criticised in terms of; draining away resources, diluting management focus and misallocating of capital (see Roever, 1992). Indeed, the additional services outlined in the Section 4 should be assessed in terms of whether they are *complementary* products and services[3] i.e. complementary to the business of property investment.

In analysing the drivers of product range diversification and expansion, there are a number of theoretical explanations derived from the theory of agency and monopoly power (see Montgomery, 1994 for a full discussion). An alternative view, termed the resource allocation hypothesis, places relative stagnation in the market for the core product as being a fundamental motivation to increase product range. A basic tenet is that where resources are being under-used, a firm has an incentive to expand. In this particular context the under-used resources are the tenant base and the associated business opportunities presented by vertical disintegration in other business sectors. However, there is only an incentive to exploit economies of scope when the under-used resource is relatively illiquid. Again, in this particular context, it would appear that there is partial liquidity in the business opportunities provided by property owners relationships with their tenants in that the property owner can transfer some of their knowledge and information to third parties.

5.3 The Business Models

The broadband example highlights the range of options that property owners have when faced with arranging the provision of services. Basically, for any service the options for organising provision include

- Joint venture
- Direct provision
- Sub-contracting

[3] Activities are defined as complementary when the cost of producing one reduces the cost of doing the other

- Subsidiary

Although all are currently used to some extent, the decision will depend on the nature of the service to be provided and the characteristics and preferences of the property owner. The discussion above has already highlighted examples of JVs (joint ventures) for the provision of e-procurement and broadband. However, where the property owner has no competency in the provision of a well-established business support services such as IT support, recruitment and human resource management, legal and, accounting advice, the owners tend to develop partnerships with established firms who become the landlord's preferred provider. It is possible to envisage situations where this will be either on the basis of the whole portfolio or single asset/proportion of portfolio.

A number of issues need to be addressed in each arrangement, most importantly the question of who manages the customer relationship? Or, from the customer's perspective, who is the provider? The key distinction here is likely to be between professional and non-professional services. Businesses are more likely to need to have the assurance of recognised brands when dealing with relatively high cost, professional services. Direct provision will tend to occur where the property owner has some core competency in the relevant service. Obviously, this is likely to be in the area of property services, such as FM, relocation and fit-out services. However, there has been limited use of direct provision models. For instance, Arlington and Prudential have essentially formed a network of service providers to support their business development.

Figures 1 and 2 illustrate how the pattern of services procurement by occupiers may evolve. Currently, the majority of landlords are not involved in the provision of property-related and business support services to their tenant base. These functions are typically provided 'in-house' or outsourced to a range of independent providers. As Figure 1 indicates the property owner has usually no relationship with these service providers. The basis of this research is that the landlord has the opportunity to become both an intermediary and a provider. The service may be provided either directly by the owner, by a provider appointed by the owner, by a subsidiary of the owner's business or by a joint venture with a service provider.

The nature of provision will also be closely related to pricing method. Where the landlord has direct responsibility for service provision and revenue collection, the ultimate decision about price is at the landlord's discretion. The issue is whether the landlord charges directly for a service or wishes to receive returns from service provision through the benefits of an improved property offering. These benefits may include higher rental incomes and improved customer/tenant satisfaction. This distinction was described by one interviewee in terms of a choice between 'skimming' charges for services against providing 'good value' to the tenant. A further complication is that there is no reason that there should be a clear choice between either model. Whilst individual services will have different optimal patterns of provision and charging, the level of trade-off between rent and revenues will vary with property owner. Discussions with interviewees suggested that in the majority of cases, investors will tend to opt for transparent of pricing of individual services rather than a 'bundling' model.

Figure 1 **Current Model of Occupier Services Procurement**

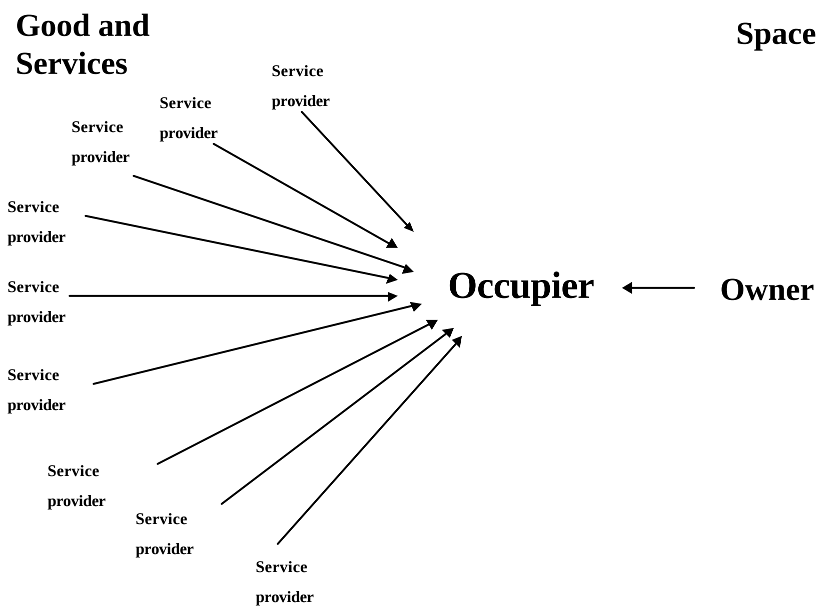
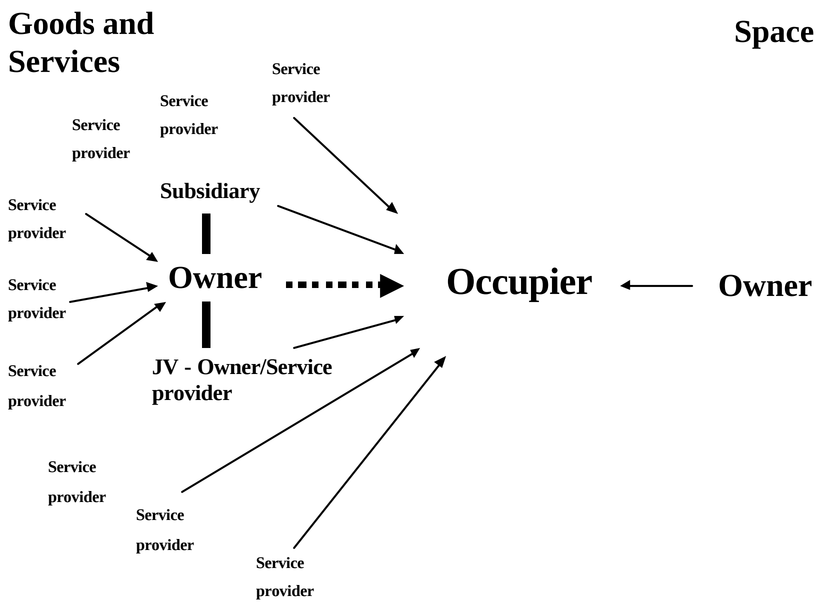


Figure 2 **Potential Model of Occupier Services Procurement**



5.4 Barriers and Scenarios

It seems clear from this analysis that the interactions of changing business structures and new technology are creating demand for and facilitating the provision of a range of business support services. In addition to the advantage of scale, existing relationships and knowledge of the building and tenants provide landlords with an obvious head start in the development and exploitation of the business opportunities. However, the extent of the opportunity is limited to where landlords are the optimal provider. Property owners by definition are the optimal providers of space but it is not obvious that they are the optimal provider for property-related services and, indeed, other services.

5.4.1 A limited market?

Given the pervasive role of procurement in the value chain, one of the obvious objectives of any commercial organisation will be to optimise this function. Of course, optimisation cannot be judged solely according to cost minimisation with impact on product quality and risk of non-production being other critical variables. The nature of the procurement itself will be crucial whether it is a one-off, straight re-buy or modified re-buy since each has different cost-benefit implications. It seems relatively certain that landlord intermediation offers potential for SMEs to access the benefits of the economies of scale achieved by larger organisations. Such organisations are likely to welcome intermediaries who can share risk and profit, guarantee minimum prices and supply. Moreover, in terms of the attraction of e-procurement, SMEs are unlikely to have the resources and technology skills to develop their own strategy. On the other hand, for larger corporations should have well-established supplier networks and partnering arrangements. A key factor for large corporations is likely to be organisational structure with the balance between centralisation and decentralisation being fundamental. The arguments for the economies of scale produced by corporate centralisation against the increased responsiveness and flexibility associated with decentralisation have been well-rehearsed. Hence, for the individual business unit of a large corporation the degree of autonomy in procurement will be a significant variable.

5.4.2 A core competency? Stick with what you know.

Further, the history of business development has provided numerous examples of the obvious ‘winner’ losing out to more entrepreneurial and nimble competitors. Questions remain as to whether property owners and managers have the skills to exploit the opportunities generated by outsourcing. Quinn and Hilmer (1995 p. 4) have argued that businesses needed to develop

> “Effective strategies [that] seek out places where there are market imperfections or knowledge gaps that the company is uniquely qualified to fill and where investments in intellectual resources can be highly leveraged.”

The key issue in this case is whether property owners are ‘uniquely qualified’ to exploit the opportunities presented by business disaggregation or whether they are merely conveniently placed. In many areas where outsourcing is possible, the sector is relatively immature and there are often few established providers. The result is that there is not sufficient quantity and quality of service providers. For property owners to be successful in these sectors, they need to be able to make it their core competency. This has been defined as a sector where they can achieve definable pre-eminence and provide unique value for customers. Whilst, the head start of property owners is obvious in many sectors, their ability to exploit it successfully is less apparent.

5.4.3 Institutional barriers

The configuration of the property sector may also create institutional barriers to the development of new business opportunities. One interviewee argued that, in contrast to the pressures on property companies to innovate, fund managers lack incentives and could even suffer penalties by providing services. Since mandated[4] fund managers are often remunerated on the basis of a proportion of asset value, the income from the additional value generated by services could be far below the additional costs involved in the provision of the services. It was argued that separate arrangements would have to be made by the fund manager with the client to ensure that an appropriate margin (as opposed to actual losses) was obtained by the fund manager. Another interviewee indicated that attempts to exploit services opportunities were opposed on the grounds

[4] This term refers to situations where the investment management organisation is separate from the ownership of the property. It has become common for the major funds to organise themselves in this manner. For instance, Standard Life Investment Management is the fund managers of the Standard Life’s property portfolio. However , they are organised as a subsidiary to Standard Life and actively seek other mandates.

that they required the recruitment of additional non-property staff and that many of the areas were outside the core competency of the company. This is undoubtedly true. Howard Bibby, the Managing Director at Arlington, has often proclaimed on the shift in personnel and culture that is required to develop a service ethos. It was also suggested that 'headcount' was an important issue for many fund management organisations and that strong justification would be required to enter labour intensive markets. A further issue is the management approach of the fund. Where the property management functions are outsourced to a provider of property management services, there may be potential problems of misalignment of interests. A property management service provider, for instance, may have a conflict of interest acting as an FM service provider for the tenant and an asset management service provider for the landlord for the same asset.

5.4.4 Liquidity effects

It was also pointed out that services provision may reduce the liquidity of property assets. One interviewee felt that the return of relatively marginal additional revenue associated with some services did not justify entering into contracts for service provision which may affect the flexibility to dispose of the asset. As a result this factor was being considered when assessing the potential of individual buildings for services provision. This was reinforced by another comment that there is a tension between wishing to preserve asset liquidity and at the same time being viewed as secure long term suppliers by their tenants. However, other interviewees regarded this issue as much less of a problem and suggested that it was relatively straightforward to arrange service contracts that could be assigned or terminated upon asset disposal.

5.4.5 Inertia effects

Further a distinction between old and new buildings was identified. For the existing tenanted buildings, it was argued that, except for new services, it would be difficult to persuade tenants to start to change their supplier of services relative to a new building. For instance, the cost of rearranging metering equipment was cited as a (not insurmountable) barrier to provision of utilities. In essence, it is expected that there are physical and cultural barriers to any attempt to 'retro-fit' a new management culture onto an existing building. Alternatively, with new premises and new tenants, the landlord was in a position to introduce a different template. As a result, it was argued that the growth of services provision was more likely in new buildings.

The view was also expressed a further barrier on the client side was the tendency for turkeys to lack enthusiasm for the festive season in that existing ‘in-house’ providers of service have little incentive to explore the potential of alternative means of procuring their services. However, although undoubtedly a genuine issue, we should be wary of placing too much weight on this argument since it would imply very little outsourcing in any sector.

It is difficult to assess how the market will evolve. The speed of evolution and adoption will vary according to the characteristics of the building, the occupier and the owner. It is apparent from the discussion above that different types of tenants are likely to have different levels of demand for services. There is also an important distinction between multi-let building and single tenancy premises. The former tends to require more management involvement than the latter and are also more likely to contain the critical mass of SMEs. The size and location of the building will also influence the viability of offering services with the additional complication that different services will have different viability thresholds. Given variations in incentives and business culture, it is also relatively apparent that different types of property owner will exploit the opportunities at different speeds and to different extents.

The Adoption of Services Provision – Market Scenarios

Scenario 1 - Full Engagement	*Effects on pattern of occupation*	*Eff*
• Property owners proactively develop the opportunity to service the tenant base. • Property owners commonly provide FM services to occupiers. • Property owners (or coalitions of owners) combine with major utilities providers to provide a range of utilities to the majority of occupiers. • Property owners offer a range of web-based services to the majority of their tenants. • Property owners offer broadband services in majority of premises. • Property owners develop JVs and strategic alliances with business support services providers to offer a range of procurement and consultancy services and products	• Bundling of space-services packages commonly occurs. • Diversity of space-service-flexibility packages increases dramatically • Property management functions are transformed	• Heteroge structures • Market tr • Non-rent substanti return • Complex increases
Scenario 2 - Low Hanging Fruit Only	*Effects on pattern of occupation*	*Eff*
• Property owners opportunistically service the tenant base in high quality, multi-let, large-scale schemes. • Property owners provide FM services to occupiers in high quality, multi-let, large-scale schemes. • Property owners (or coalitions of owners) combine with major utilities providers to provide utilities in high quality, multi-let, large-scale schemes. • Property owners offer a range of web-based services to tenants in high quality, multi-let, large-scale schemes. • Property owners offer broadband services in high quality, multi-let, large-scale schemes. • Property owners develop a limited number of JVs and strategic alliances with business support services providers to a limited number of new products and services.	• Bundling of space-services packages occurs in high quality, multi-let, large scale schemes • Diversity of space-service-flexibility packages concentrated in high quality, multi-let, large scale schemes. • Increased diversity of property management functions. • Tiered market for properties requiring intensive and limited management	• Heteroge increases property • Market tr certain ca • For the m rental reve proportio • Complex increases property
Scenario 3 - Proceed with caution	*Effects on pattern of occupation*	*Eff*
• Property owners 'defensively' service the tenant base • Property owners provide FM services to occupiers only where the property and tenants demand it. • Property owners leave provision of utilities to occupier • Property owners fail to offer a range of web-based services to tenants in high quality, multi-let, large-scale schemes. • Property owners offer broadband services only where and when competitive pressures force them. • Property owners largely ignore the business support services sector.	• Bundling of space-services packages rarely occurs. • Diversity of space-service-flexibility packages is rare • Property management functions fail to change. • Specialist market for properties requiring intensive and limited management	• Limited c sector . • Market tr stable. • Non-renta for a sign income r • Complex remains s

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6.0 Valuation Issues

6.1 Introduction

Whilst it is apparent that there is unlikely to be a dramatic, short-term transformation in the nature of property revenue streams, it is plausible that there will be significant growth of services provision by property investors in the medium to long term. The revenues generated will have a range of risk-return characteristics which may have indefinite and complex attachments to the asset. This section attempts to examine in depth the implications for commercial property valuation.

In order to provide a context for the discussion, a brief analysis of current valuation process, procedures and methodology is firstly provided. The second part reviews recent precedents where either the nature of the property income stream or a change in market conditions have produced difficulties for valuers. This is then followed by a review of formal guidance on 'going concern' valuations. Finally, the fundamental issue of attributing value is assessed.

6.2 Valuation methodology in the UK

Guided by the Red Book in the UK, the objective of a valuation is to estimate the exchange price of an asset subject to a number of a assumptions about marketing period, buyer and seller motivations and market conditions. With often, subtle variations, this is essentially the approach in most national markets. However, the methodology for achieving this objective is not as consistent.

In the UK, the majority of mainstream commercial property assets are valued by the income approach. This involves the application of a capitalisation rate (the all-risks yield) to the income stream. In essence, it is a comparison approach. The capitalisation rate is generally derived from the analysis of market transactions involving comparable properties. Given the effects of the heterogeneity of the property market, thin trading and lengthy transaction times, valuers are required to adjust market derived capitalisation rates to reflect variations between comparables and the subject property. The main task of the valuer is to obtain data on market transactions and perceptions and apply this information to the subject property. Consequently, the efficiency and reliability of this method is dependent upon the availability of transaction evidence. Where income profiles are similar, for instance, where is single lease structure dominates the market, capitalisation rates derived from transactions involving comparable assets with similar income streams will provide a good indication of market value. Relative homogeneity in income profile is, therefore an important variable. It seems reasonable to propose that the more heterogeneous income profiles become, the less efficient will be comparison methodologies.

The valuation profession in the UK is also increasingly being asked to provide calculations of worth. The Red Book (Definitions, p.3) defines the calculation of worth as

> "The provision of a written estimate of the net monetary worth at a stated date of the benefits and costs of ownership of a specified interest in property to the instructing party reflecting the purpose(s) specified by that party"

It is evident from this definition and from the appropriate guidance notes that the appraiser is being channelled towards identifying particular circumstances of individual clients and incorporating these circumstances to calculate individual worth. This is conventionally carried out by an explicit discounted cash flow analysis based on inputs derived from the client and/or appropriate research. However, it is important to distinguish between discounted cash flow being used to assess price and being used to assess worth. Although discounted cash flow techniques can be used to estimate both price and worth, a crucial point is that the inputs will usually be derived from different sources and produce different outputs.

In the US, where explicit discounted cash flow techniques are used both to estimate exchange price (termed 'market value') and to assess individual worth (termed 'investment value'), there is unequivocal guidance on the approaches to both types of discounted cash flow and the varying information requirements. For market value it is stipulated

> "To avoid misuse or misunderstanding when DCF analysis is used in an appraisal assignment to develop an opinion of market value, it is the responsibility of the appraiser to ensure that the controlling input is consistent with market evidence and prevailing market attitudes. Market-value DCF analyses should be supported by market-derived data, and the assumptions should be both market- and property-specific. Market-value DCF analyses are intended to reflect the expectations and perceptions of market participants along with available factual data." (The Appraisal Foundation, 2000, Uniform Statements of Appraisal Practice, Statement 2, Discounted Cash Flow Analysis)

This is approach to inputs is contrasted with the calculation of worth. In this context the statement's key attribute is its emphasis on market knowledge and the necessity of inputs being derived from market expectations rather than appraiser/client expectations. To reiterate, although the methodologies are identical, the information requirements are crucially different.

6.3 Plus ça change…….

In order to illustrate the effects on valuation methodology, below a number of precedents are discussed where the normal income approach has been regarded as inappropriate and the 'solutions' proposed are outlined. There are a number of precedents which shed some light on how valuation methodologies influence market change and are, in turn, influenced by market change. Currently, a good example is the valuation of flexi-leases. One of the factors hindering the valuation of flexi-leases is the lack of transactions providing evidence of market values. Valuers are faced with the task of the attempting to adjust market data which does not incorporate flexi-lease characteristics. Indeed, the valuation problem is commonly cited as an obstacle to the supply of this type of lease. A consequence has been the development both by practice and academia of alternative valuation models. Although the models are confidential, there have been a number of presentations of their method. It is interesting to note that they have involved the application of insights from option pricing theory and the use of simulation techniques (see McAllister, 2001).

Previous experience of short leaseholds, over-renting, lease inducements and abnormal rent review periods has illustrated how market changes tend to be associated with uncertainty surrounding and new developments in valuation methodology. Typically, as conventional valuation methods are unable to reflect reliably the financial consequences of new problems, issues of pricing efficiency have emerged. For example:

- The anomaly of short leasehold pricing due to the archaic assumptions to traditional leasehold valuation methodologies lead to increased use of DCF techniques.

- The flaws in 'slicing' methods of valuing over-rented properties lead to increased use of growth explicit (including 'short cut' DCF) techniques.

- The problem of abnormal rent review periods lead to the emergence of constant rent theory.

Other examples are discussed in greater depth below.

6.3.1 Hotels

The valuation of hotels provides some useful insights into how non-rental revenue streams tend to be appraised. Hotels are property assets which generate revenue from a range of profit centres inextricably linked to the hotel. These often include restaurants, bars, valet/laundry services, gym/health club, conferences, telephone systems, car parking etc. Hotels incorporate a range of intangible assets such as

- Working capital
- Assembled, trained and skilled workforce
- Brand
- Advanced reservations
- Past customer lists

They are, therefore, atypical of most commercial property investments. Although profits and direct comparison methods are widely used for appraisal, it is notable that discounted cash flow methods are commonly employed for the valuation of hotels in the UK. Typically the net present value of the projected net income flow is taken to represent the open market value of the hotel. Indeed it is accepted in the UK that for hotels the going concern value represents the open market value of a hotel.

It is also interesting that case law and practice have distinguished between the value of the going concern and the value of the property. The Judge in *Corisand Investment Ltd v Druce & Co.* (1978) clearly defined going concern value in terms of the amount that an operator might pay for the right to generate the income flows.

"The purchaser would calculate what he could expect to earn in the hotel as it stands, or as he could make it operate, and what price it is sensible to pay for the right and opportunity to earn that income. The valuer tries to make the same calculation." *Corisand Investments Ltd v Druce & Co.* (1978).

However, a distinction was drawn between the going concern value and a 'bricks and mortar' value. The latter was defined as going concern value less goodwill and contents and assuming "that the new operator will have to generate profits" (Borner, 1994, p.298). This is essentially a valuation assuming that the concern is not going and that the operator will enter a 'shell and core'. The task is to estimate the price that an operator would pay for rights to (re)start a hotel operation as opposed to take on a business that is ongoing. Another interesting feature of hotel valuation in the UK is that, unlike mainstream commercial property investments, it has been historically carried out by accountants as well as chartered surveyors.

6.3.2 Turnover Rents

Unlike other major property markets, turnover rents have until recently been relatively rare in the UK[5]. One reason proposed to account for this fact has been the attitudes of valuers who tend to 'downvalue' rents linked to turnover. This, in turn, is perceived to inhibit investors from introducing turnover rents (see Hawkings 1990; Lewis, 1989; Walsh, 1988). Essentially, in the absence of sufficient trading volume and a detailed understanding of the investment performance of turnover rents, valuers tended to apply high risk premia to this type of income (see McAllister, 1996). However, discussions suggest that turnover rents have become more prevalent in the last five years. Associated with more recent retail innovations, turnover rents have now become well-established in regional shopping centres, factory outlets centres and retail functions associated with transport interchanges (airports, rail stations and motorway service stations). Anecdotal evidence suggests that, in the absence of adequate trading volume, valuers normally tend to use discounted cash flow techniques to appraise assets generating this type of income flow.

[5] Most new schemes now have a turnover element in the rent.

6.3.3 Service charge surpluses

Where premises are multi-let, common area maintenance costs are recovered through a service charge to tenants. Typically tenants pay a proportion of the service charge which relates to the relative importance of the occupation ie. a tenant occupying 10% of the total lettable space pays 10% of the service charge. However, in some cases, the lease may specify that the tenant pays slightly more than a pro-rata calculation eg. . a tenant occupying 10% of the total lettable space pays 12.5% of the service charge. Where this is standard for all tenants, the landlord is able to cover more than their costs and is able to generate an income from the service charge surplus. One interviewee stated that when valuing this type of income flow, typically a multiplier ranging from 1-3 was applied to it. Indeed, it was stated that some clients were sensitive about the issue and wished for it to be excluded from the valuation. However, it was stressed that such incomes are generally insignificant relative to the core rental income, consequently and typically rather crude techniques were often used to value them.

6.3.4 Long leasehold residential investments.

One interviewee also highlighted an interesting example of where the prices paid for investments did not seem to reflect the financial value of the income stream. It was argued that prices paid for the ground rents of long leasehold investments in the residential sector were often in excess of 'rational' economic values. It was suggested that part of the explanation for the apparent anomaly lay in the ability of landlords to obtain additional revenues through the provision of additional services eg. insurance commission. This is also supported by recent research on the Leasehold Reform Act where landlords claimed that their return from ownership consisted of more than ground and rent and reversionary value (Dixon *et al*, 2000)

6.3.5 Shopping centres

In the early 1990s the valuation of regional shopping centres was subject to a degree of controversy. In essence, some investors/owners felt that traditional valuation methodologies were inappropriate. It was argued that the problems of thin trading and 'obsolescent' comparables were heightened for regional shopping centres. The result has been a shift away from capitalisation rate approaches to shopping centre valuation towards the more general use of discounted cash flow techniques. It is also worth reiterating that, unlike other mainstream property assets, shopping centres also tend to generate non-rental revenue from parking, advertising and other concessions[6].

6.3.6 *The business (enterprise) value debate in the US*

The 1990s have seen a debate in the US concerning the possible existence of business enterprise value associated with but separate from underlying real estate assets. The source of the debate originated in attempts to argue for a reduction in taxation liabilities for real estate investors since local taxes were payable on real estate value but not other tangible and intangible assets. It is most commonly associated with the leisure sector where business value is identified as the value of "an established operation in an established location with an established staff, having an established reputation" (Fisher and Lentz, 1990, p. 169).

The definition of business enterprise value has also been the subject of some ambiguity. A common understanding is that it reflects going concern value minus the market value of real estate and other tangible assets. However, a more restrictive definition found in the empirical research is that it is the capital value of the rent received minus market rent (see Owens, 1998). In the latter, it often represents the value added by the good management of an asset. Much of the debate in the US has focused on the appraisal of hotels and retail malls and the term 'operational entrepreneurship' has been coined to describe it. For retail malls, business value is identified as stemming from a number of sources:

[6] Typically such revenue accounts for a small proportion of total revenue

- management expertise producing an optimal tenant mix,
- effective tenants' association,
- good promotion and marketing.
- brand name value associated with the tenant covenants.
- the detailed terms of the leases and occupational agreements, particularly with magnet stores.
- other income from car parking charges and license agreements.
- management/service charges and related income.

Miller *et al.* (1995) question the evidence for the existence of business value and argue that in a competitive, dynamic market "entrepreneurial value" (super-profits) will not persist due to market entry or that income related to "excess productivity" eventually becomes attached to the property rather than the business. Following the logic of land residual theory they argue that:

"the argument for separating out business value obviously exists when an appraisal includes a going-concern value as part of the total appraisal, but such going-concern value should be based on the net expected profitability of the business entity given that a competitive rent is already paid. There is no reason to expect any component would be passed on to the owner of the real estate, beyond the competitive rent that is paid." (Miller *et al.* 1995, p.206)

This does not address the definition of a 'competitive rent'. The productivity of a location will be affected by the quality of the space-service blend that a landlord can offer. It seems reasonable to assume that tenants will pay more rent for premises that are well-managed, provide access to a range of business support services and that can consequently improve the business profitability. In the same way that high risk tenants often tend to have to pay higher rents than low risk tenants[7], it is likely that tenants will pay more to locate in premises of high quality landlords and service providers relative to low quality landlords. There are precedents.

[7] A good example is serviced office providers in the early 1990s. Crosby *et al* (2000) found that operators tended to have to pay "premium" rents in order to secure premises.

We have already noted the broadband example where it is held properties with this service may be able to achieve higher rentals (albeit in the short term). Further, one rationale put forward by an institutional investor for not taking a margin on discounted utilities was that a return could be obtained from the benefit of lower service charges leading to higher rents. In essence, the point is that part of the value generated by the landlord's management or service provision will become embedded in the rent. However, the existence of this value only exists where the landlord provides or is perceived to provide **above average** quality space-service products and where the rent-setting process permits the incorporation of the effect of this entrepreneurship into the rent.

Given the potentially large sums involved, it is no surprise that there has been litigation and consequent case law on business value. A key issue that emerged related to whether the value could be transferred separate from the property. This distinction was summarised by a US State court decision[8]:

"The key is whether the (income) value is appended to the property, and is thus transferable with the property, or whether it is, in effect, independent of the property so that the (income) value stays with the seller or dissipates upon sale"

Again, this may be an oversimplification. For instance, 'premium rents' paid due the quality of the landlord's operational entrepreneurship will remain for the period of the lease or until a review to open market. Although they may not be sustainable and are dependent upon the exising owner's management skill, they can be transferred with the property but may dissipate upon a re-negotiation of rent with a new owner[9].

[8] JMB Group Trust IV v Board of Review of the Village of Greensdale *et al*., Wisconsin Court of Appeals, District 1, July 23, 1992.

[9] In the UK, given the specific procedures regarding rent-setting at lease renewal and rent review, landlords would find it difficult to argue for uplifts to reflect their superior management ability.

6.4 Issues From Valuation Guidance (the Red Book)

The valuation of non-standard income streams has generally been associated with going concerns such as hotels and public house. Although a building which generates non-rental income streams to the landlord is not a going concern in the conventional sense, the nature of the income profiles is often similar. The key difference is that in typical going concerns the tenant occupies and generates income streams associated with the property. In this case, the landlord is not in occupation and is simply providing a range of services to a business located in the building that they also own and have let to the tenant. This is an important distinction from a serviced office operator and is discussed further below. The latter typically has legal occupation of the building. Nevertheless, guidance on going concern valuations provides some interesting insights into issues that may arise. The issues have been classified according to whether they relate to valuer competence, allocation of value, apportionment of value and approach and assumptions.

6.4.1 Competence

One of the objectives of this research project had been to assess whether a growth in non-rental income streams associated with property has implications for valuation education and training. It is clear from the analysis so far that valuers may commonly have to deal with the valuation of unfamiliar and complex income flows. A fundamental principle of the Red Book is that

> "The Valuer must be able to demonstrate that he has, in respect of the type of property, ……..the skills and understanding necessary to undertake the valuation competently" (PS 5.1.1)

Not unsurprisingly, where valuers lack confidence in their competence to appraise more complex income streams, other professionals tend to be used. The area of hotels is one example. In the case of serviced office, it was found that one major firm tends to use the expertise a subsidiary economics consultancy when appraising these income streams. Another interviewee commented that their valuation team had recently recruited a number of professionals from finance and accountancy backgrounds in order to enhance the skills base within their firm. A number of respondents were sceptical that valuers had the range of skills to cope a shift towards increased use of DCF methodologies and business valuation techniques.

6.4.2 Allocation and Apportionment

One of the primary opportunities identified for landlords is to exploit the potential to aggregate the buying power of their tenants in order to achieve lower prices and to generate additional income. Whether these income streams are attached to the building or to the owner's business is a difficult issue. Undoubtedly, arrangements to procure on the tenant's behalf can continue independent of ownership of the property. However, this is currently exceptional. The Red Book allows valuer discretion on the issue.

> "Profits by way of bulk discounts for the purchase of goods may be taken either at head office or attributed to individual branches. The valuer must be aware how these have been treated and make the necessary adjustments" (GN 7.2.6)

The potential additional value generated by sectoral or geographical concentrations of assets is also acknowledged.

> "When a valuation is provided of a portfolio as a whole or in parts and it exceeds the aggregate total of the valuations of the individual properties, this must be pointed out and the reason for the opinion given" (PS 7.5.21)

In terms of attributing value to the different individual elements of the income stream, the Red Book also has something to say about apportionment.

> "Whilst it is possible as a hypothetical exercise, the Valuer must emphasise to the Client in his Report, that the resultant figures are informal apportionments and that the individual figures do not themselves represent the open market value of the elements involved, since the valuation can only be the figure taken as a whole" (PS 2.7.4)

It might be difficult to defend this 'caveat' when the single figure represents the sum of the individual figures.

6.4.3 Assumptions and Approach

Although the Red Book has little to say about methodology, it makes a number of points concerning approaches to the valuation of going concerns. For instance, it is clear that the valuer should be familiar with the business sector that generates the additional income.

> "When valuing properties by reference to trading potential, the Valuer will compare trading profitability with similar types and styles of operation and a proper appreciation of the profit potential of the relevant sector is essential" (GN 7.2.12)

Sensibly, it makes clear that

> "Regard must be had to the business mix and to the risk associated with each of the income streams" (GN 7.2.7)

6.5 Attribution of value

The critical issue concerning attribution is whether income falls to the property or to the landlord. Two key questions emerge

(i) Is it reasonable to expect that the income stream will remain with the property upon disposal?

(ii) Does the generation of revenues from the provision of services affect the revenues from rent?

Although it has already been noted below that there is an emerging recognition that the different elements of the income stream in a property investment can be stripped out and sold separately, it is also clear that investors do feel that some of the revenues from services provision are inextricably linked to ownership. In the case of broadband, existing owners feel that it very unlikely that they would retain broadband revenues from an asset subsequent to disposal of the freehold. In essence, the rationale was that prospective purchasers would regard it as an encumbrance to their management of the asset. Thus, liquidity, investment demand and values may be adversely affected. Where contracts exist, the solution has been to allow for them to be assigned upon disposal.

With regard to the second question, the bundling of space and service provision, especially where there is a unitary charge, has the potential to create problems of market transparency for valuers. Valuers have always experienced problems in making price and valuation adjustments to reflect non-standard lease terms. For instance, differences in liability for repair and maintenance have tended to be accounted for by crude measures. It is possible to identify a number of potential effects.

- *Blurring* - where unitary charging occurs it may be difficult to disentangle the charge for the rent and other services. A good example is serviced offices where the tenant pays a single charge for rent, flexibility of entry and exit, office infrastructure, running costs and support services.

- *Substitution* - particularly where some of the services are high margin, landlords may opt to accept a lower rent to obtain contracts to provide these services. This is analogous the activities of companies such as CE Capital and Roll Royce who sell capital equipment at a loss where they can secure the contracts to maintain, service and finance the purchasing of the equipment. Alternatively, the landlord can opt to provide services at cost (or even below cost) in the expectation of achieving higher rents instead of additional revenue streams.

- *Enhancement* - where the services are better than average, tenants may pay a higher rent to access them (as long as superior provision of services exists). This is likely to place increased importance on factors such as branding, reputation, quality of business model etc. In many cases, rental 'premiums' paid for access to superior services will not be sustainable as other property owners react and mimic. However, owners able to establish a strong reputation and brand may be able to maintain higher rents in the medium to long term. Further, it is implicit in the defensive motivation of a number of major property owners that the objective is to maintain rental income rather than generate additional revenues. We have seen below that the purposes of investors in providing services has been to makes tenants 'stickier' in order to reduce the costs associated with tenant vacation.

It is evident from this discussion that, in addition to generating additional income, the provision of services is capable of having compound effects on the rental income stream from a property asset. It is possible to envisage circumstances where the valuer will need to be able to allocate the rental income (separate from income generated by payment for services) that is being paid for

- the occupation of the property,

- the provision of services where no explicit charging takes place,

- access to the ability to source high quality services and, if appropriate,

- the provision of these services by an organisation with an established reputation, successful track record and brand.

Further, the valuer may have to assess whether the extent to which a 'premium' rent is attached to the property. As we have noted above, typically it will dissipate either after a sale of the building to a new owner or the setting of a new rent.

6.6 Space with services or serviced space?

An issue that emerged from the interviews was the point at which an asset in which the landlord provided a substantial range of services to the occupiers became a owner-occupied property used for operational purposes. Where a serviced office operator owns the freehold interest and provides a range of services to occupiers who occupy through a licence rather than a lease, the valuer is generally dealing with a property "occupied for the purposes of the business". In this case there is no tenancy since the occupier does not have exclusive possession. In the UK, owner-occupied premises are typically valued on a vacant possession basis (set out in the definition of Existing Use Value) with a notional void allowance often incorporated in the valuation to allow for letting delay. Normally, although not universally, this produces a value lower than on an open market value basis. Consequently an interesting question concerns the point at which an owner providing services invalidates tenants' exclusive possession. Given the level of management input in shopping centres, the level of service provision needs to be very significant before this point is reached. It would tend to occur where the distinction between providing services to tenants and providing serviced offices to businesses became negligible. It is very unlikely that there will be a shift towards very short-term, flexible provision of both space and services.

7.0 Conclusion

The last decade has seen a fundamental shift in the ways that many occupiers and investors regard property assets. Advisers, owners and occupiers are increasingly financially aware and innovative. The growing trend for occupiers to outsource property support services and seek flexibility in occupation has been driven by the interrelated forces of new technology, globalization and increased competition. There is very little likelihood that this will be reversed. It is illustrative that two of the most significant developments in the property sector – the growth of corporate PFI-type models and serviced office provision have at their core the outsourcing of property and other support services. In the UK, a number of major landlords have argued that these structural shifts provide an opportunity to transform the nature of their business relationships with tenants. In particular, there is a perception amongst some owners that performance can be improved by providing a range of services in addition to space.

It is important to be realistic about the main activities in which landlords are likely to become involved. New business opportunities are likely to be associated with the occupation of the property, new technology or infrastructure and the growth of e-procurement. The main areas identified here are FM, relocation services, procurement of non-property goods and services, e-procurement capabilities and broadband. The expansion of landlords into provision of back-office functions, financial services, human resource management and other mainstream business support services seems premature.

The speed and extent of any change are difficult to assess. Motivations to enter the market are twofold. For a minority of owners, it is perceived as a method of developing a new revenue stream whilst enhancing the core property business. This is a standard motivation for expansion of the product range. However, a motivation less commonly cited in the literature was that for a significant proportion of major institutions, the motivation is essentially defensive. This motivation does not indicate a confidence that there are large pools of untapped revenue that landlords have to date neglected. Nevertheless it is certainly perceived that occupiers will increasingly demand additional services and that landlords who can meet this demand will at minimum protect and hopefully enhance portfolio values.

It is apparent that the pace of adoption will vary according to building, owner and tenant. The extent of adoption depends partly on the ability and enthusiasm of property owners to enter these potential markets. Given that many institutional investors deliberately acquire investments that minimise management input, it is difficult to envisage rapid change from this source. It is likely that any change will be lead by the quoted sector which is itself quite diverse. For individual buildings the viability of services provision is influenced by a matrix of level of demand, nature of service and proximity to other assets. The level of demand will, in turn, be influenced by the tenant mix. Large multi-let buildings with a range relatively dynamic, small and medium-sized enterprises seem to offer the most potential.

There are a number of significant barriers to the expansion of the sector. In the long term, there are two key issues

(vii) Is it a core competency? There is a perception that diversification into the provision of services distracts management from its core tasks and can adversely affect performance in other areas.

(viii) Are the services complementary? There is no consensus that the additional services are complementary in the economic sense. There is scepticism that property owners have the necessary skills and infrastructure to compete on price and quality with specialist providers of goods and services.

The answers to these questions will vary from service to service and will in turn influence the degree of involvement by the property owner in delivery. In the short-medium term, there are a number of additional issues.

(ix) Asset and fund managers feel pressure to minimise 'headcount' and costs.

(x) Current remuneration structures for mandated fund managers provide limited incentives to develop new revenue streams

(xi) There are potential conflicts of interest issues for outsourced asset managers who involve themselves in the provision of services to tenants.

(xii) For the existing portfolio, there is a perception that there are significant costs for occupiers and owners associated with the disruption of existing procurement and management models. Market entry is likely to be easier where tenants are in the process of taking new space.

Where landlords do enter this sector, it is unlikely that they will typically act as direct providers of services. Rather for many services they will tend to leverage their existing relationship and reputation to act as intermediaries, quality guarantors and risk sharers. It seems clear that some landlords intend to become the hub of a network of service providers to their business tenants.

Previous experience of the valuation of over-rented properties, lease inducements and abnormal rent review periods has illustrated how market shifts tend to be followed by confusion surrounding and new developments in valuation methodology. Typically, as conventional pricing methods are shown to be unable to reflect accurately the financial implications of market change, problems of pricing efficiency have emerged. A key variable is the existence of a market standard or the degree of heterogeneity in the market or sub-sectors of the market. Where there is a market standard e.g. a significant proportion of leases are on standard terms – a 15 year FRI lease with five yearly upward only rent reviews, pricing can take place against this benchmark. In this situation a direct comparison approach is practicable. However, the absence of a reliable benchmark of market prices means that a different basis for relative adjustment is required. Further, although the relative size of the sums involved are often very small, the valuation of turnover rents, service charge surpluses and additional non-rental income suggests that valuers tend to adopt crude and simplistic valuation models.

In business entities characterised by blurred boundaries and symbiotic relationships, allocating value becomes increasingly problematic. There is potential for change in the nature of rent due to bundling of property and services. Conventionally in the UK rent has represented payment for the right to occupy a property for a specified time period. However, where landlords start to provide services in addition to property and introduce 'bundled' charging structures, the distinction between revenue from rent and charges for services becomes less clear. This is heightened where landlords explicitly introduce services to improve rental returns rather than to generate separate revenue streams directly. Where landlords also 'bundle' the provision of services with flexibility of exit by providing break clauses or short leases, the lack of transparency is further exacerbated.

A key conclusion is that where income profiles become less predictable and more heterogeneous, valuers tend to adopt explicit discounted cash flow techniques for the purposes of estimating market price. The valuation of shopping centres, hotels and serviced offices are revealing precedents of this trend. The use of discounted cash flow techniques both to estimate individual and market *worth* and to estimate market *price* provides scope for confusion in terms of the different information requirements. In the US and Canada where, discounted cash flow techniques are used for both functions, guidance is very explicit on the need for information on market expectations to provide the basis for estimates of market price.

As noted above, valuers may find the task of estimating the underlying rental payment for property difficult in the absence of 'trading' in a standard lease structure. This is the crux of the problem. Comparison approaches rely on relative heterogeneity in transactions to provide a benchmark against which deviations can be compared. The benchmark of a 15 year full repairing and insuring lease with five yearly upwardly only rent reviews is unlikely to disappear in the short term. However, in the medium to long-term it is possible to envisage a situation where landlords offer a whole host of occupational solutions to their tenants. Where diversity dominates, the traditional income methodologies will become obsolete. However, this is a point for the long term rather than the short-term and past experience suggests that valuation processes adapt to market changes.

Transferability and liquidity of additional income streams is a key issue. Although financial engineering allows investors to 'unbundle' the different income streams from property assets, it is apparent that certain revenue streams are inextricably linked to ownership of the property. Revenues from (and contracts associated with) the provision of services such as broadband, utilities, car-parking and advertising are generally transferable with the property to a new owner. In turn, other revenue streams generated from the tenant base such as payments and contracts for FM services or fit-out/relocation are unlikely to be portable in the same way.

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Appendix 1

List of interviewees

Stephen Spooner	British Land
Francis Salway	Land Securities Trillium
Deborah Davies	Hermes
Susan Roche	Legal and General Investment Management
Alex Bennett	Grosvenor Estates
Steven Lee	Brixton Estates
David Arthur	Slough Estates
Richard Jones	Morley (telephone interview)
Gillian Rushmore	DTZ Debenham Tie Leung
Oliver Close	Healey and Baker
Matthew Cripps	Knight Frank
Philip Cropper	CB Hillier Parker
James Hamilton-Stubber	Jones Lang Lasalle
Brenna O'Roarty	Jones Lang Lasalle
Andrew Lomax	Drivers Jonas