Property Viewpoint

BLME
BANK ON OUR PRINCIPLES

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The rise of the trophy asset

London's most well-heeled districts are seeing a new wave of super-wealthy inhabitants.

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Infrastructure finance – can it boost the economy *and* investor returns?

Georgian houses in Kensington and Chelsea

The rise of the trophy asset

Once the home of neighbourhoods of the nobility, where stern-looking nannies pushed big-wheeled perambulators along their leafy streets, London's most well-heeled districts are seeing a new wave of super-wealthy inhabitants.

The 15 square kilometres around Hyde Park, famed for its Mary Poppins-esque stucco fronted Georgian townhouses and grand cobbled streets, have since the mid-20th century lost much of their residential flavour as many of the grandest London homes have been converted for other uses such as offices and flats.

Embassies and high commissions for foreign governments occupy more than 180 of the grandest London houses, most of them in Mayfair, Marylebone, St James', Belgravia, Kensington and Chelsea.

But as central London values soar, long leases start to expire and modern diplomacy continues to evolve, even governments are coming under pressure to sell up to the super rich and move to less established locations in the city such as the new Embassy Quarter development south of the river.

According to estate agent Wetherell estates, in 2013 a total of 20 embassies and other diplomatic buildings in central London have been sold or put up for sale as governments wake up to the fact they can sell up to house-hunting billionaires in search of a family home or property developers looking to build prestigious apartment schemes.

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Estimated price of the Canadian High Commission sold in November 2013 to Indian property company Lodha Group – more than six times the amount it was valued for in 1999.

In November the government of Canada sold its 160,000 square foot Canadian High Commission building in Grosvenor Square in Mayfair to Indian property company Lodha Group for an estimated £306 million – more than six times the amount it was valued for in 1999.

"There was exceptional interest from international parties for the property on Grosvenor Square," Gordon Campbell, Canadian High Commissioner, said in a press statement.

The sale follows news earlier in the year that the former Brazillian Embassy on Green Street in Mayfair had been sold for £40 million as staff moved to new offices in Cockspur Street, SW1.

The UAE Government is also reported to be talking to consultants about leaving its current 2,800 sq metre prestigious address at 30 Prince's Gate in Kensington and setting up in a square foot facility in Ballymore's 240,000 sq metre Embassy Gardens scheme in the Nine Elms regeneration area south of the river.

And the Chinese government, which occupies 20,000 square feet up the road at 49-51 Portland Place has instructed the property agent CBRE to put its embassy on the market.

Agents say the building could be redeveloped as up to 60 luxury flats.

The Chinese are rumoured to be in talks with Royal Mail about buying its 52,000 square metre mail depot in Nine Elms for a new embassy although it is also thought to be considering sites in Earl's Court in west London and Wapping in east London.

The current wave of migrations comes in the wake of the United States' decision back in 2008 to leave its famous 21,000 sq metre 24 Grosvenor Square headquarters in Mayfair after selling the long leasehold to Qatar Investment Authority.

The Americans will be moving in 2017 to a purpose-built highly secure 58,000 sq metre facility at in the much more affordable Nine Elms site.

The £600m 11-storey building, dubbed the "glass cube" by Londoners, is due to be completed by 2016. It is expected to be an anchor of the "new South Bank" stretching between Battersea and Vauxhall, which also includes the £8bn Battersea Power Station development. The station was bought by a consortium of three of Malaysia's biggest companies, SP Setia, Sime Derby, and the Employee's Provident Fund, for £400m last year.

The US was followed in April by the Dutch government, which is hoping ▶

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to sell its current 2,300 sq metre embassy at 38 Hyde Park Gate in Kensington and move next door to the Americans in south London.

"I can confirm we will sell our current building as it is too big and not suitable for modern diplomacy," says a spokesman for the Dutch government. "The sale will contribute to government cuts going through at the moment."

According to figures from the British government body Land Registry, residential prices in prime central London grew 7.5 per cent during the twelve months to the end of September 2013 to stand at an average of £1.48 million.

For properties worth more than £5 million (73 per cent of which were for houses) the number of transactions increased by 7 per cent.

"In this super prime sector of the market the dynamics seem to have shifted," says Naomi Heaton, chief executive of prime London investor London Central Portfolio. "We seem to be seeing an increase in this category in the number of family home purchasers."

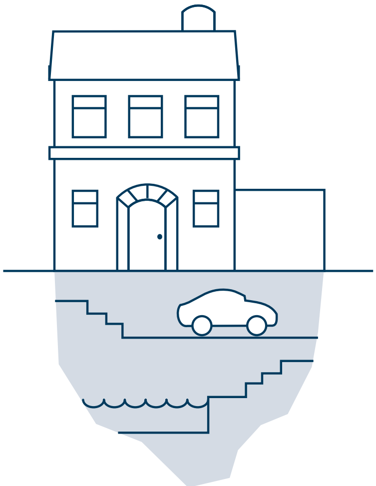
Alice Myers is interested to see if one key trend of 2013 continues into 2014 "with more single units that have significant amounts of space underground, sometimes referred to as "iceberg houses" which probably does no justice to the efficacy of the state of the art heating and air con systems standard in this sector." Myers continues "the future of these iceberg houses depends largely on the outcome of the ongoing planning authorities discussions."

One of the areas most affected by the migration has been Kensington Palace Gardens, dubbed by many Britain's Billionaires Row.

Separated off from the busy main roads by imposing wrought iron gates and armed police checkpoints, the almost 1km long tree-lined avenue of Italianate and Queen Anne-style mansions is home to celebrities including Russian oligarch and Chelsea Football Club owner Roman Abramovich, model Tamara Ecclestone, the daughter of Formula One boss Bernie Ecclestone and the Sultan of Brunei, Hassanal Bolkiah.

And overseas governments including those of Russia, India, France, Nepal, Finland, Lebanon,

Artist's impression of the US Embassy at The New Embassy Gardens at Nine Elms on the South Bank, known locally as the "Glass Cube".



Alice Myers, Head of Property Finance, BLME expects to see a key trend of 2013 continue well into 2014 with more developments of "single units that have significant amounts of space underground, sometimes referred to as "iceberg houses" which probably does no justice to the efficacy of the state of the art heating and air con systems standard in this sector."

"Kensington Palace Gardens is a trophy address, possibly the best there is. In the same way a hotel like the George V in Paris sells for far more than its real value – trophy assets attract a premium that doesn't correlate with the intrinsic value of the property."

Ed Mead
Director, Douglas & Gordon

Kuwait, Japan, Slovakia, the Czech Republic, Romania and Norway own many of the long-leasehold properties as either embassies or ambassadors' residences.

But here too governments have come under increasing pressure to sell up to the super rich who are willing to throw more and more cash at acquiring the trophy buildings in the street.

In 2004 the Russian oligarch Leonard Blavatnik bought number 15 Kensington Palace Gardens by acquiring three former Russian embassy buildings for £41m.

And in 2008 the Indian steel magnate Lakshmi Mittal, who owns 41 per cent of ArcelorMittal, the world's largest steel making company, paid £117m to buy the long leasehold of 9A, the former embassy of the Philippines, making it the most expensive house in the UK at the time.

This year the Nepalese government has revealed it is controversially considering selling its embassy at 12A, which doubles up as an official ambassadorial residence. Government officials sent a committee to London to explore the option of offloading the mansion, which was gifted to the Nepalese in 1937 by the British in thanks for the Gurkhas' role in the First World War and other campaigns.

Such a deal could fetch the developing country as much as £150m despite the fact that the property has had little maintenance for 50 years and is said to require more than £5m of repairs.

Agents representing Mr Mittal are understood to have already expressed an interest in the property and other key names are also said to have been privately approached. However, the Nepalese government says it is still making up its mind about the future of the 2,970 sq metre historic house, which Gurkhas regard as a key part of their history.

"I want to make it clear to you that the government has not taken any decision, so it all depends on the recommendation of the team," the Nepal foreign ministry spokesman Arjun Thapa told the BBC this year.

"Kensington Palace Gardens is a trophy address, possibly the best there is," says Ed Mead, a director at Douglas & Gordon. "In the same way a hotel like the George V in Paris sells for far more than its real value – trophy assets attract a premium that doesn't correlate with the intrinsic value of the property," he adds.

"And in a world where 'mine's bigger than yours' is what counts, they don't come much bigger than this."

Infrastructure finance – can it boost the economy and investor returns?

As Britain begins to emerge from the global financial crisis, the search is on for new ways to fund the sort of large scale projects which can provide a much needed economic boost.

So called infrastructure projects such as airports, roads, railways, power stations not only provide jobs for the people building them but also provide a boost to the economy.

But with the traditional funders of these mega projects, the banks, still nursing the scars of the crash and the government lacking the funds (or often the political will) to pay for them, scores of schemes such as plans to upgrade the A21 in Tonbridge near Kent or to build a bypass around the town of Grantham in Lincolnshire are hanging in the balance.

According to think tank the Centre for Economic and Business Research (CEBR), a lack of infrastructure spending by successive governments is costing the UK economy £78 billion a year. It conducted a report, commissioned by the Civil Engineering Contractors Association (CECA), which ranked the UK's infrastructure 24th in the world and proposed that the government should set a floor to ensure infrastructure spending does not fall below 0.8 per cent of GDP.

And Britain is far from alone. Around the world governments are searching for ways to help pay for expensive infrastructure projects which they started planning in a very different economic environment.

In China the government is working on its twelfth five year plan which includes a staggering list of new infrastructure requirements including airports, ports, oil and gas pipelines, power lines and new hospitals throughout the country.

In Mexico the government has announced a US$314 billion national infrastructure plan in the highways, ports, airports, rail and

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telecommunications sectors. And throughout the developing world in the countries of Africa, Asia and South America similarly ambitious projects can be found.

One solution could be plans announced this year by a series of global pension funds and other major investors which hope to exploit the hole left by traditional bank funding to launch their own infrastructure debt funds.

In January Allianz Global Investors, one of Europe's largest asset managers, announced that it was to launch a £1 billion infrastructure debt fund. Six months later the fund provided €127 million debt to fund a 36,500 square meter music cultural centre on Paris's Seguin Island and in October it provided €165 million to build a bypass in Marseilles.

"This underlines the development of institutional financing of infrastructure assets in France and elsewhere in Europe," says Francois-Yves Gaudeul, director in Allianz's infrastructure debt team. "Our institutional funding can be put in place from the construction phase of a project."

In June Europe's second largest insurance company Axa announced that it would lend up to €10 billion over the next five years to infrastructure projects around the world in a move which it said was part of its credit diversification strategy and was suited to its needs as a long term investor.

↓ **£78bn**

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"Our decision to increase our exposure to the infrastructure debt asset class is in line with our global investment strategy," says Axa's group chief investment officer, Laurent Clamagirand. "It meets our need to find long term investments and diversify our credit portfolio and also demonstrates the role insurance companies can play in financing the real economy."

And both Belgo-Dutch insurer Ageas and French insurance company CNP Assurance have recently signed deals with French bank Natixis, one of the biggest project finance lenders in Europe, to put together their own infrastructure financing platforms while Natixis scales back its own lending in the sector.

The pension funds are tempted by the fact that infrastructure investments provide an alternative source of high yielding assets. Infrastructure funds tend to offer better returns than bonds with cash yields on investment grade infrastructure schemes reaching 7 or 8 per cent.

Moreover, the long periods of time it takes to complete building bridges, roads and airports usually means that it takes a long time for investors to receive their return, closely matching the liabilities of insurers' annuity and guaranteed investment products and in theory providing better security for the pensioners of tomorrow in the developed world.

Analysts from think tank Deutsche Asset & Wealth Management Global Financial Institute, energy infrastructure is one of three asset classes along with commercial real estate, farmland and forestry, which has tended to perform in a way not correlated to other assets such as shares, bonds and gold when tracked in the US from 1996 to 2012. This means that investors can reduce risk without reducing expected returns.

According to Standard & Poor's, funds operating outside banks are expected to offer $25bn in European project finance loans this year, up from zero two years ago.

"We believe this nascent market will initially revolve around direct lending to projects at the lower end of the investment-grade spectrum either by institutional alone or jointly through debt funds as well as through private placements," says David Prowse, senior director for insurance at Fitch Ratings in a note in June. "It will eventually develop to include a functioning project bond market and the entire investment grade category." ▶

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So is infrastructure investment really such a fool proof plan?

Certainly, in its report on infrastructure Deutsche Asset & Wealth Management Global Financial Institute, author Martijn Cremers points out that although its publicly available data from 1978 to 2012 shows that uncorrelated returns have in the past come from energy pipelines, there is not enough data from other forms of infrastructure to draw the same sort of conclusion.

And, he adds, just because investments behaved that way in the past, it doesn't mean they necessarily will do the same in the future when far more investors are showing interest in the asset class.

Mr Cremers points out that in his sample of 800 defined benefit pension schemes surveyed between 1990 and 2010 less than 1 per cent held any infrastructure investments at the beginning of the study. However, by the end of the study, 28 per cent of the funds invested in the asset class.

It could be possible, he suggests that the funds studied over the time period benefitted from a sort of first mover advantage and that these kinds of assets behave differently over time as more investors pile into the sector.

There are other risks too inherent in the sector. In the end such investments are really an investment into an operating business which is often taking on huge construction risks with the enormous projects they are undertaking. They can be prey to construction delays, poor management, unforeseen complications and delays and even corruption. Even with pension fund investors keen to put their cash only into the highest investment grade schemes some risks still remain.

Certainly although UK chancellor of exchequer George Osborne said in his National Infrastructure Plan in 2010 that he hoped private investors would stump up 64 per cent of the £310 billion needed to build new railways, airports and power stations, little of that money has come forward.

"We are not convinced a plan requiring £310 billion of investment in infrastructure is credible given the current economic climate, the cutbacks in public finances and the difficulty in raising private finance for projects on acceptable terms," a Commons Public Accounts Committee said in April.

But with the economy picking up interest in mutual funds which invest in infrastructure projects seem to be increasing.

According to researcher Morningstar, the dozen mutual funds which are already active and have "infrastructure" in their names gathered more than $1 billion from investors during the first half of the year – beating the $749.7 million that the funds attracted in all of last year.

In June the European Commission unveiled a framework to encourage private European long-term investment funds into the sector which it hopes could raise as much as €2 trillion for projects needed up until 2020.

According to the Commission, the funds will typically invest in schemes too illiquid to be held by traditional European collective investment schemes (which must allow redemptions at least twice a month). Under the new framework investors in infrastructure funds might not be able to withdraw their cash for as long as 10 years after they put their money in.

"In exchange for their patience, investors would benefit from the regular income stream produced by the investment asset and possibly collect an illiquidity premium," the commission said in a statement.

Whether any of these new schemes will actually come off is of course another matter. However, with a chronic need for new infrastructure around the world and a search from investors to find returns, what is certain is that the hunt is now on to – quite literally in some cases – bridge that gap.