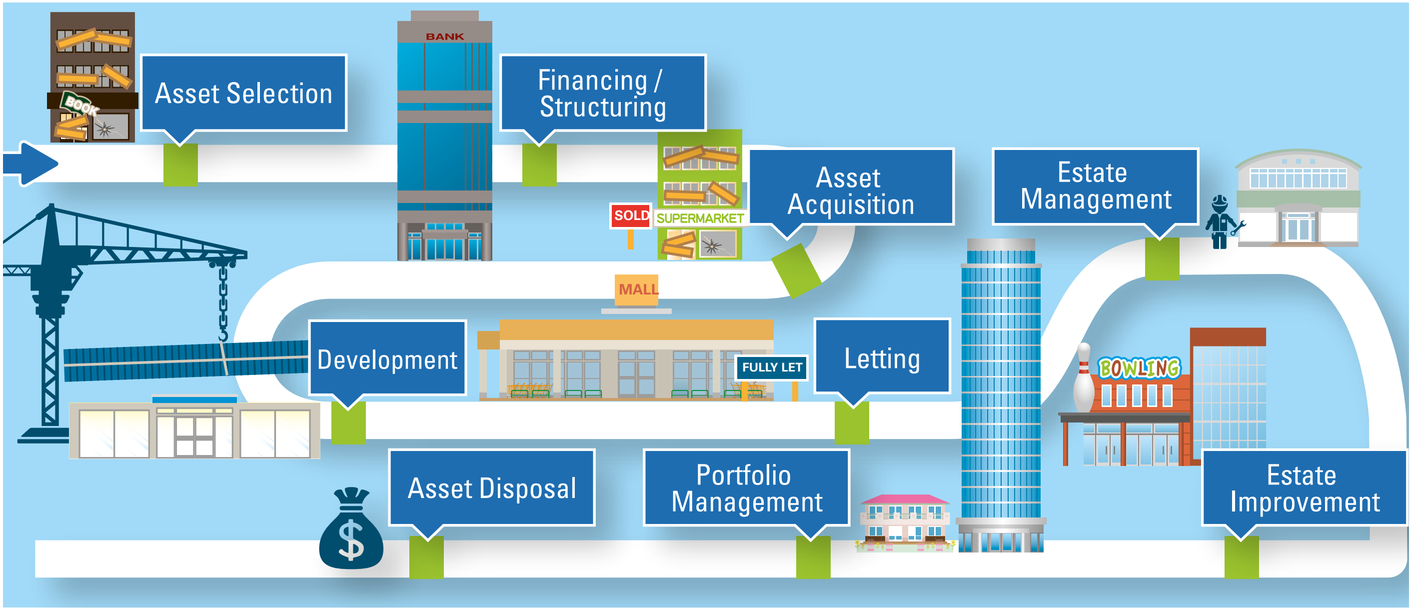
Real Estate: Are you providing a complete picture of business value?



By looking beyond net asset value, real estate annual reports may be able to give investors a more complete picture of value in the business.

It is natural that the focus of real estate reporting and investor communication is on the real estate assets themselves. This does not tell the whole story, though. A broader view of value creation is needed if the long term earnings potential of a business is to be properly understood.

Companies have the opportunity to fill these reporting gaps by taking a look at how their reporting aligns with their business model and where the value lies in their business. Below we have highlighted four areas of a typical real estate business model where reporting may be out of line with the value in the business.

The suggestions we have made will not be relevant for every business - each company's value creation story is unique. Business reporting should reflect this by being built around the company's business model, strategy, and operating environment, rather than a set of compliance based disclosures.

Four suggestions for Better Business Reporting in the Real Estate sector

1. Don't let asset revaluations obscure the value added through site development

Many real estate businesses are adept at generating a stream of value gains as they move assets through their development pipeline. This value stream can be an important part of overall value but the gains being generated can be obscured by asset revaluations.

A business that can create value by obtaining planning consents where others cannot, or that can manage its building costs better than others should have a value advantage. If asset development is important for your business, readers will want to understand this stream as part of the overall picture of management's performance and also for understanding its ability to deliver development gains in the future.

The first step in helping readers understand this is to provide greater visibility over each stage of the development pipeline. Many reporters highlight the progress made in developing selected assets, but this does not provide a complete picture. A profile of the development pipeline from unconsented opportunities through to pre-let developments (for example by sq. foot) is one way to highlight overall progress.

The second step is to show how management has added value as it has moved assets through this pipeline. This is key to understanding the performance of the development side of the business. Insight into the potential for value creation can be gained by looking at management's track record in adding value to completed developments. Reporters can help readers understand this by separating out development gains and costs from the related asset holding gains.

2. Asset improvement programmes have different value drivers to new developments – Separating the discussion can help readers understand the value added.

Discussion of asset refurbishments and extensions is often reported as part of the overall development process where the focus is on square footage added to the estate. For improvements that also benefit other parts of the estate, this may not show the full extent of value added. A clearer view may be provided by reporting on this as a separate activity.

This is particularly relevant for retail assets where changing consumer behaviours are driving demand for different classes of asset. In this context, a refurbishment or leisure development on a part of the estate may enhance the value of the whole estate, although it may take a number of years for this value to come through as rent reviews and tenancy changes are completed. The challenge for readers is to link the appreciation of asset values to management's improvement initiatives because the short term financial impact may be limited.

Reporters can help readers do this by explaining how they expect the profile of rents on the whole asset to change, rather than simply concentrating discussion on the new asset. A track record of benefits derived from similar past improvements may help readers to judge the potential value created.

3. Readers' assessment of rental security may be helped by aligning the different information being reported

Much of the information companies report on rental income security (lease break periods, tenants in administration, industry exposure, covenant strength, etc.) is of limited value in assessing income security because it is provided in a disconnected form. This prevents readers from developing an overall profile of rental income stream risk. Companies may be able to give readers greater confidence in the security of future rental income by presenting this information in a more aligned way. For example, indicators of covenant strength are most relevant for categories of tenants with a significant default risk – an aggregate picture may be of limited value.

4. Don't overlook value added through the asset sale, purchase and letting process

The competitive advantage that some businesses have during the purchase, disposal, and letting of assets can add significant value over time, but the extent of this advantage is often not visible. The advantage may stem from better contacts, financial strength, purchasing power, or simply more sophisticated negotiating strategies. Whatever the source, readers will want to understand the value it can generate and whether it represents a sustainable advantage.

Management's track record in 'beating the market' by selling above and purchasing below market value can provide an indicator of the ability of the business to generate transaction gains in the future. Explaining how the advantage is being protected can give readers greater confidence over the extent to which this can be sustained.

Realigning your reporting with business value

We encourage report preparers to see these ideas as a starting point for identifying ways to improve their dialogue with investors rather than the end point.

We believe that narrative reporting should reflect the unique features of each business. For those looking to explore this further, we suggest three challenges to start your improvement journey –

- Tell your value creation story on your terms by building your reporting around your business model instead of a disclosure checklist
- What constitutes a 'good year' for your business? Are you giving shareholders the information to look beyond the short term financial performance to see this?
- Ask yourself whether the information provided enables shareholders to form a view over the long term prospects and value in the business

Contact us:

Better Business Reporting

Matt Chapman
KPMG in the UK
T: +44 207 311 3236
E: matthew.chapman@kpmg.co.uk

Real Estate

Andrew Marshall
KPMG in the UK
T: +44 207 311 6456
E: andrew.marshall@kpmg.co.uk

kpmg.com/integratedreporting

RR Donnelley | RRD-281230 | April 2013