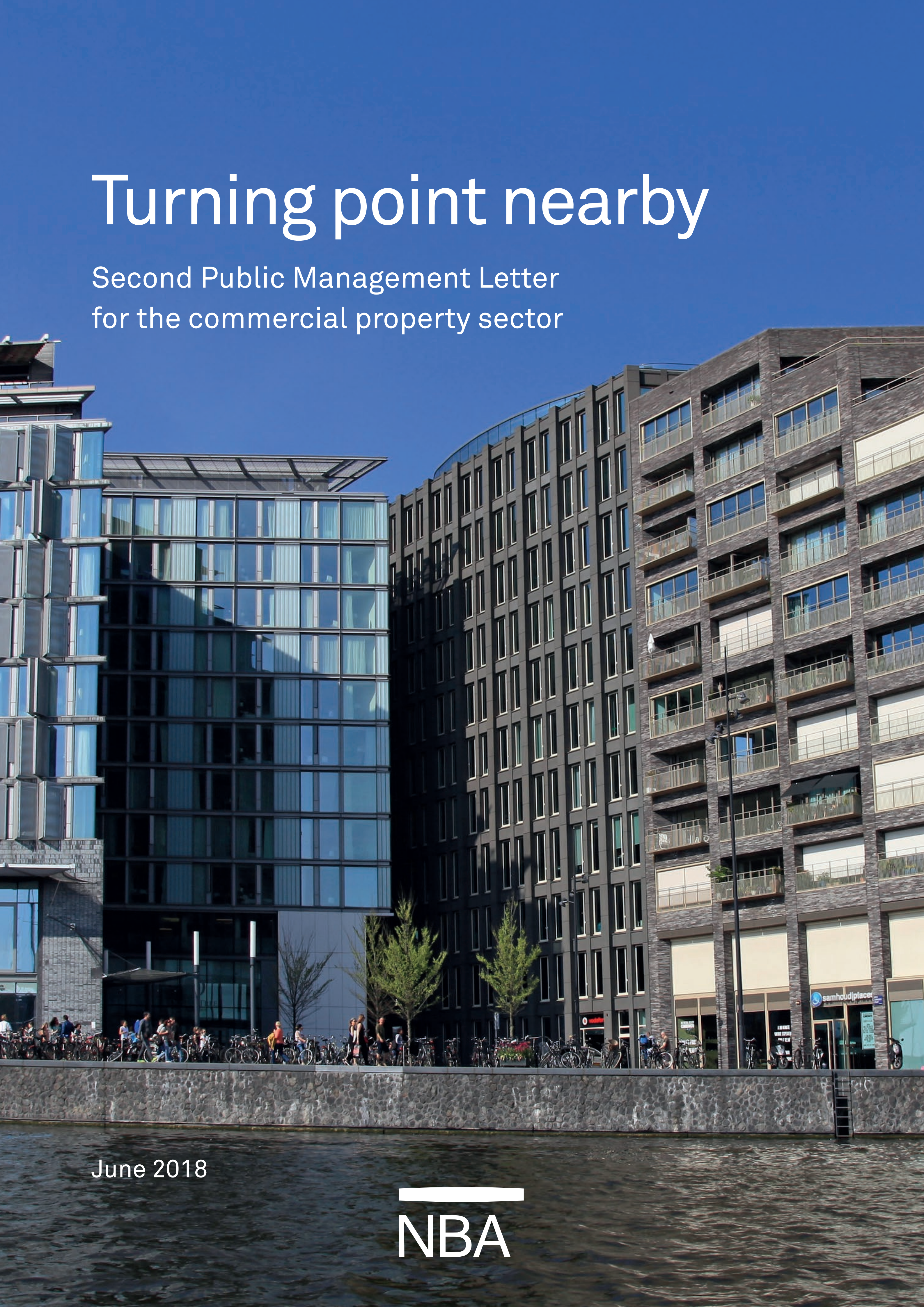
Turning point nearby

Second Public Management Letter for the commercial property sector



June 2018

NBA

Royal Netherlands
Institute of Chartered
Accountants

NBA

The NBA's membership consists of a broad, diverse occupational group of over 21,000 professionals working in publicaccountancy practice, at government agencies, as internal accountants or in organisational management. Integrity, objectivity, professional competence and due care, confidentiality and professional behaviour are fundamental principles for every accountant. The NBA assists accountants to fulfil their crucial role in society, now and in the future.

To directors, supervisory bodies and other
stakeholders in the property sector

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Amsterdam, June 2018

Dear Sir/Madam,

The NBA released its first Public Management Letter (PML) about the commercial property sector in 2011, which was entitled Tell it like it is. At the time, the sector had been hit hard by the economic crisis and the letter resulted in six signals and sixty-five recommendations being formulated. Now in 2018, the situation has changed completely: we are seeing record investments in property, rental prices and values are increasing, there is insufficient supply in certain parts of the sector and banks and other financiers are willing participants once again.

The property sector is normally characterised by a cycle of peaks and troughs and the upward trend has now been ongoing for a few years. Naturally, this is causing people to question when the turning point will be reached. It is thus important for property companies to implement an effective long-term vision and strategy, where consideration is also given to setbacks and negative scenarios. That is the main message in this second PML about the commercial property sector, which is entitled 'Turning point nearby'.
The letter has identified five signals:

1. The sector is a long way into the cycle
2. Innovation is leading to profound changes
3. The property sector is also a target for cyber crime
4. Outsourcing increases susceptibility to fraud
5. Homes are becoming more like an investment

The sector will do well to learn its lessons from the previous property crisis and ensure sufficient equity when the tide turns in the current economic climate. Innovation and cyber security are also worthy of attention, partly in light of the energy transition and global agreements concerning the reduction of CO2. The increasing trend of maximising the outsourcing of property services to third parties has caused an increase in the likelihood of potential fraud. Finally, scarcity in the housing market and the arrival of more and more property investors into the market, can lead to unrealistic pricing.

A lot of hard work still lies ahead, despite the major strides taken since the previous crisis. This is not only demonstrated by the above mentioned signals, but also by the analysis carried out into the signals and recommendations identified in 2011. If the sector wants to be future-proof, it will also have to pay full attention to recommendations that are still outstanding.

This PML is based on the knowledge of our members in the NBA Commercial Property working group. Various organisations, including the Netherlands Authority for the Financial Markets (AFM), the Dutch Central Bank (DNB), the Dutch Association of Institutional Property Investors (IVBM) and the Dutch Banking Association (NVB), made their comments aware to us, both verbally and in writing, when this PML was being compiled. Their contribution is highly appreciated.

Royal Netherlands
Institute of Chartered
Accountants

NBA

Yours faithfully,

Pieter Jongstra RA
Chairman NBA

Prof.dr. Martin Hoogendoorn RA
Chairman NBA Identification Board

Turning point nearby

NBA

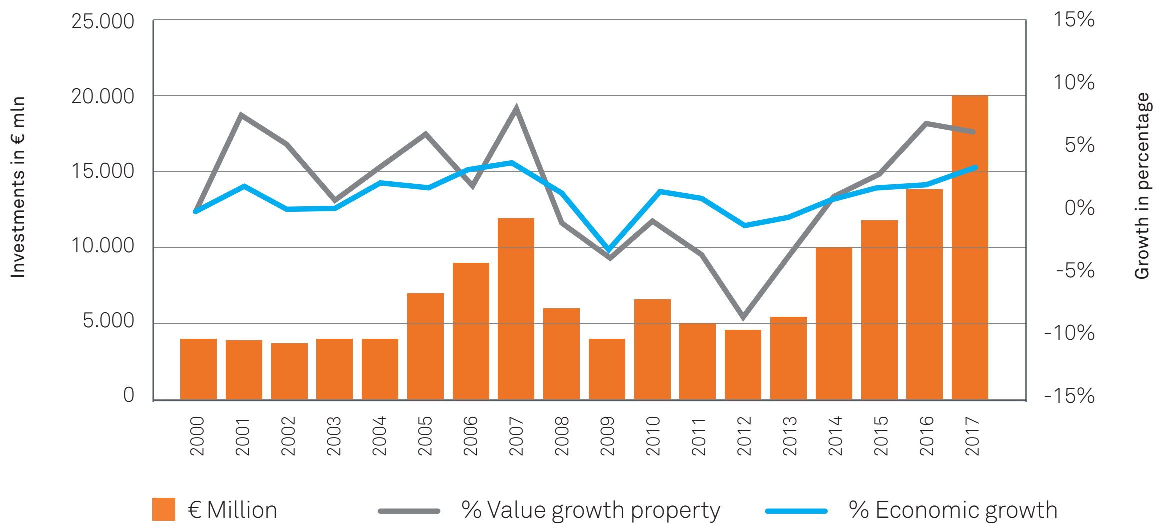
Content

A lot of work still needs to be done

An overview of 2018

The property sector has experienced major growth in recent years. Investment volumes continue to increase each year and international investors have also targeted the Dutch property market in huge numbers. Banks are heavily involved in property financing and rental prices are rising. 2017 was a record year for investments in Dutch property. The diagram below shows the upward trend in investments and value growth. Since 2016, the increase in property values has actually exceeded economic growth.

parties even being fully aware of it. In this regard, not a great deal has changed compared to 2011. At the time, the sector was under scrutiny due to one of the largest property frauds of all time and was suffering from the financial and economic crisis. The sector has recovered in the meantime, partly due to low interest rates and the desire of investors to make returns. One could even say that the pinnacle of the property cycle is now behind us. For instance, cases have come to light where initial yields are lower than the previous crisis. How long will it take for downward corrections on valuations to be implemented



Source: Colliers, ASRE and DNB, reworked by NBA

However, this does not mean all problems in the property sector have been resolved. In a situation where transaction volumes are reaching unprecedented heights and initial yields are well on their way to historic depths, the market is still difficult to read. Financing risks are increasing again and valuations seem to be surrounded by a high degree of valuation uncertainty, without all

and how long will interest rates remain at historically low levels? What will be the consequences of a turnaround in the overall economic climate? Has the sector built up enough resistance in the meantime to withstand the next crisis?

Follow-up of recommendations 2011

A lot of things have improved since the signals and recommendations in the 2011 PML, but certain important issues still need to be addressed. This is the main conclusion one can draw in 2018. For instance, the assumptions and suppositions used in property valuations could be better substantiated and the required attention could also be given to the energy transition and the consequences of new IFRS reporting regulations for leasing contracts. Although financing problems have decreased due to historically low interest rates, there are signals that interest rates are slowly creeping up again. Some property companies are still struggling when it comes to risk management, culture and conduct and there is still no public register which makes all property transactions public. The risk of decreasing values, because property is not made sustainable in good time, has not gone away, certainly when one considers the already mentioned energy transition as well as global agreements concerning the climate. Finally, it is still important for accountants to evaluate the recommendations from 2011.

Five new signals

The property sector continues to be a very dynamic sector, hence the need to identify new signals. Innovation, cyber crime, outsourcing and scarcity in the housing market must be addressed in the visions and strategies of property companies. They are also accompanied by their own risks, for example, with regards to continuity, valuation and risk management.

This is why the NBA has decided to release a second PML, after the first PML for commercial property was released seven years ago. The new PML not only looks back at the old signals, but also establishes five new signals for the future.

The fact that the PML primarily focuses on commercial property, does not mean it cannot be useful to everyone with any kind of involvement in property. Whether this concerns other parts of the property sector, organisations that possess property or even supervisory bodies and policy-makers working for the government.

On the other hand, considering the diversity of the property sector, not every signal in this PML need apply to every part of the sector.

Follow-up to PML *Tell it like it is*

The PML entitled *Tell it like it is*, which was released in June 2011, featured six signals:

1. Structural vacancy levels threaten the office market
2. Need for financing and refinancing is underestimated
3. More focus should be placed on good governance, internal control and fraud prevention
4. Valuation should gain in transparency
5. Non-sustainability leads to decline in value
6. Property business requires specialist accountants with professional scepticism

Below, each signal has been examined based on the situation encountered in mid-2018. The overarching recommendation from 2011 has also been mentioned under each signal:

1 Structural vacancy levels threaten the office market

Overarching recommendation:
Provide understanding of the implications of high vacancy levels for valuations

The high rate of vacancy in the offices market was caused by the crisis and the over-supply of offices. The recommendations involved prevention, looking for solutions for vacancy and attention to the consequences of vacancy on valuations. At this moment in time, mid-2018, the rate of vacancy is considerably lower in the offices market, but this can mainly be attributed to the current economic climate and the desire of investors to achieve returns. Aided by a shortage of homes, part of the problem has also been resolved by eliminating over-capacity and implementing rezoning. In addition, many municipalities have become more reluctant to issue planning permission for new offices. On the other hand, new vacancy has also been encountered, for example, in shops. However, there is now greater focus on the consequences of vacancy. The annual accounts provide greater insight into suppositions implemented for valuations, as well as the level of vacancy within portfolios. In this regard, many of the recommendations from 2011 have been adequately followed up.

To recapitulate, this is how things stand in 2018[1]:

- Vacancy has generally decreased, although there is still a lot of office building vacancy in certain areas. This has partly been caused by the emergence of shrinkage regions.
- During the period 2011-2016, there was actually an increase in shop vacancy (followed by a slight decrease in 2017) due to an increasing concentration of shopping areas in urban areas, a sharp increase in internet sales and a number of bankruptcies among retail chains. This means a more critical approach is being taken to investments in retail property.
- There is a shortage of high-quality office space and large surface areas in, for example, the Randstad. This means, for instance, that top locations must be spread throughout cities or regions.
- If offices are to be used for other purposes, greater flexibility should be incorporated when designing property.
- The energy transition and a lack of activity on this front in existing and outdated property, is presenting major challenges for the future.
- A better insight can also be obtained into the influence of vacancy on valuations, both in estimate reports as well as annual accounts. This, for example, relates substantiations and explanations for implemented assumptions and suppositions.
- Due to the new norm (IFRS Standard 16), which stipulates that leasing contracts must be incorporated into financial statements, a rethink is needed when it comes to weighing up ownership against

1 A proviso in this case is the absence of uniformity in vacancy-related data. Different sources provide different results.

lease. As a result, it is no longer possible to keep operational leasing contracts off the balance sheet. This has an effect on balance sheet figures like, for example, share of equity capital in the balance sheet total or the ratio between earnings before interest, tax, depreciation and amortization (EBITDA) versus interest-bearing debts.

2 Need for financing and refinancing is underestimated

Overarching recommendation:
Monitor financing conditions and duly arrange for refinancing

This signal was about punctually signalling problems concerning financing and refinancing. It was partly based on often aggressive types of financing, which meant the value of many property loans threatened to exceed the value of the security itself (the so-called 'flooding of property'). The main recommendation involved identifying potential problems and taking action in good time. There was generally a very good response to this recommendation and (re)financing has been given a prominent role in the agendas of many directors.

Mid-2018, there has been a decrease in financing-related problems, namely because a lot of restructuring has taken place and banks have become more reluctant to offer financing. But this does not detract from the fact that, partly due to increasing foreign competition in the financing market, banks are allowing less cautious financial ratios to be implemented. Financing has become more aggressive, partly due to the low interest rate. Although disputed, Solvency II regulations for insurers assume that the security in a property loan can be subject to a direct value decrease of 25 percent. This means an LTV (loan to value) of well over 50 percent cannot really be regarded as cautious.

Many signals show that interest rates will remain low for some time, but uncertainty is increasing. For instance, the European purchase programme for government bonds will be limited this year and American interest rates are slowly creeping upwards. When performing their stress tests, property companies would do well to take into account value decreases as well as interest rate increases, while also examining the more extreme scenarios. Decisions based on over-optimism are never good decisions.

3 More focus should be placed on good governance, internal control and fraud prevention

Overarching recommendation:
Organise commitment, knowledge and oversight

The main message from 2011 was that boards at property companies had to be involved in all relevant aspects of business operations, had to be familiar with all of the company's layers and implement high quality risk management.

At this moment in time, mid-2018, major cases of fraud appear to have been consigned to the past, the issue of fraud is high on the agendas of large and institutional companies, many sector organisations have compiled guidelines or codes[2] and more attention is being given to internal control and fraud prevention. The AIFMD guideline[3] pays specific attention to risk management. The *Dutch Corporate Governance Code 2016* also calls for focus on risk management, risk appetite and culture and conduct. Finally, the implementation of the fourth EU anti money laundering directive and the introduction of the Ultimate Beneficial Owner-register (UBO register) half-way through this year, can also be mentioned on this front.

Nonetheless, the sector is still struggling. Property companies are having difficulties addressing their risk appetite in relation to their strategic risks, buffer capital and specific control measures. Fraud due to collusion is still being encountered, with too little attention often being paid to culture and conduct. The sector will thus do well to bear in mind the main principles in the aforementioned governance code. The code emphasises the importance of long-term thinking, which is also essential for property companies considering the typically long-term nature of their investments.

4 Valuation should gain in transparency

Overarching recommendation:
Be transparent in the valuation

In 2011, it was confirmed that the property sector is not very transparent and that certified guidelines by third parties like the International Valuation Standards Council (IVSC) and the Royal Institution of Chartered Surveyors (RICS) were not being widely and consistently implemented. It would have been in the interest of surveyors to comply with these guidelines. All parties - surveyors, companies and accountants - were asked to develop initiatives aimed at improving valuations.

2 Beheersing van frauderisico's in de institutionele vastgoedsector ('Controlling fraud risks in the institutional property sector) (IVBN, February 2018).
3 European Union's Alternative Investment Fund Management Directive.

Seven years later, a lot has happened and the Platform Taxateurs en Accountants (PTA) has published its 28 recommendations in *Goed Gewaardeerd Vastgoed*[4]. Most of these provisions have been incorporated into the Gedrags- en Beroepsregels (GBR, 'Code of Professional Conduct') compiled by the later founded NRVT - which came into effect on 1 January 2016, to which most surveyors are now affiliated. The NRVT has many agreements with the organisations of other business service providers, for example concerning disciplinary regulations and requirements for continuing education.

The situation concerning the NRVT now appears to be stabilising. Current rules are becoming more transparent and the issue of permanent supervision is being addressed. In terms of the latter, it is advised to gain experience from other organisations like the NBA and AFM. The NRVT will also do well to close ranks, quickly address the issue of compliance with its GBR and make sure that all of the PTA's recommendations are given a place within its regulations. According to the NRVT, many of these issues have been effectively addressed in the meantime. The AFM and DNB are closely monitoring the initiatives of the NRVT and are advising the government to create clear legislation for surveyors, namely when it comes to ensuring the effectiveness of rules compiled by the NRVT. One idea worthy of consideration could involve developing a framework of report templates and sample valuations. The NVRT could also benefit by setting up a separate chamber for Large business property.

At the moment (2018), there is still no public register where all transaction data is publicly available, with regards to direct property transactions as well as property traded via share transactions. The initiative announced by the Land Registry and Stichting Vastgoeddata (StiVAD) in 2012, which aimed to create a closed transaction register[5], is a step in the right direction but only covers transactions registered with the Land Registry and not share-based transactions.

Another thing that should not be forgotten is that valuation inaccuracies can easily reach a magnitude of around 10 percent[6]. This is inherent to the encountered valuation uncertainty. Users of this information are not always sufficiently aware of this, whether they are directors, investors, accountants, financiers or even internal or external supervisory bodies.

The publication entitled '*Het nut van een vastgoedindex voor het toezicht*' (The usefulness of a property index for supervision) by Hilbers and Nijskens, also stated that transparency in the sector could be further improved[7].

5 Non-sustainability leads to decline in value

Overarching recommendation:
Give more priority to sustainability

In 2011, it was said at the lack of focus on sustainability in the planning and decision-making of property companies could have a negative impact on values. That is why attention was requested for sustainability. The sector has certainly made progress on this front. GRESB[8] and BREEAM[9] are generally acknowledged types of sustainability certifications. The government, tenants and investors are enforcing sustainability and many energy covenants are being established. The policy implemented by the EU aims to create completely energy-neutral urbanised environments by 2050. To achieve this, the EU stipulates that new-builds must be (almost) energy neutral as of 2021[10]. As a result, there is ever increasing competition between newly built and existing property. In the Netherlands, every office must have an energy label of C or higher as of 2023[11]. According to the Ministry of Home Affairs, the associated costs have been estimated at 800 million euros. Even though many publications claim this estimate is way too low, there are also doubts about the usefulness of this measure because labels are constantly changing. A more effective and intelligent approach would be to become completely energy neutral.

Therefore, there is still a genuine risk of value decreases due to delays in making property sustainable. Sustainability and the effects of the energy transition deserve more attention in property valuations and should be accompanied by an estimate for related costs and financing potential. This is one of the reasons why analysts are always questioning whether there are sufficient investments in existing property. Can one of the dividends paid to shareholders not be used to improve the resilience of property values?

4 https://www.nba.nl/globalassets/brochures/platform-taxateurs-en-accountants-pta/nba-pta-brochure-good-practices-consultatie-juni-2014.pdf
5 http://www.vastgoedmarkt.nl/geen-categorie/nieuws/2016/02/nieuw-register-voor-vastgoedtransacties-10193772
6 MSCI Private Real Estate: Valuation and Sale Price Comparison 2016 Results Bryan Reid. June 2017
7 https://www.dnb.nl/binaries/Hilbers%20en%20Nijskens%20Het%20nut%20van%20een%20vastgoedindex%20voor%20toezicht_tcm46-347047.pdf?2016122507
8 https://gresb.com/
9 http://www.breeam.com/awards/
10 http://www.energievastgoed.nl/2013/04/19/de-term-beng-bijna-energieneutraal-gebouw-is-geboren/
11 https://www.rijksoverheid.nl/actueel/nieuws/2016/11/28/alle-kantoren-verplicht-zuinig-met-energie

6 Property business requires specialist accountants with professional scepticism

Overarching recommendation:
Arrange for sector knowledge and professional scepticism among accountants

A professional, sceptical audit by accountants requires sufficient knowledge and understanding about property companies, associated risks and the environment in which companies operate. This was one of the signals in 2011. The recommendations related to sector specialisation, creation of training programmes and knowledge centres and involving relevant specialists - including surveyors and forensic accountants - when auditing financial statements.

In 2018, many accounting firms have given higher priority to sector specialisation compared to 2011. The PTA and publication of the NBA guide 1117 *Risicoanalyse accountantscontrole vastgoed (Risk analysis property audit)* were also important advances. However, there is always room for improvement and the recommendations from 2011 must be continuously evaluated: are accountants remaining critical enough? Do our reports and other forms of communication, clearly mention that property valuations are accompanied by a high degree of valuation uncertainty? It is also good to always critically evaluate the place given to the property sector within the firm. To what extent does this play a meaningful role when it comes to quality control, providing and investing in quality, attracting qualified employees and remuneration policy? Does the firm's sector group actually have enough critical mass? Are the recommendations of the PTA being implemented?

When it comes to the use of specialists, greater attention is now being paid to the conditions under which this can take place. The requirements established for property experts - when it comes to assessment, documentation and suitability - appointed by accountants and the management are being interpreted more and more strictly. Accountants must carefully examine whether they meet all requirements and whether this is sufficiently substantiated in their dossiers. Accountants must be critical about the quality offered by specialists, determine whether their assumptions and conclusions have been sufficiently substantiated and assess if the valuation interval used by specialists is acceptable.

Signal 1 |
The sector is a long way into the cycle

Reporting year 2017 was a record year for the Dutch property business. During every property event, this causes people to ask: 'in which phase of the cycle does the sector find itself?'. Has the sector learned from the previous crisis and has it built up enough resilience should the tide turn?

One of the driving forces behind the increase in property investments and a partial reason for the encountered price increases, is the historically low interest rate. Because investing in fixed income products (such as saving products and debenture loans) is not offering enough returns, investors are on the look-out for investments that offer better returns. Investment in private property funds is also higher than ever before and money collected with the purpose of investment in property has reached record heights[12]. The pressure on property funds to invest this so-called 'dry powder' is now greater than ever before. On the one hand, this could lead to overly expensive purchases and, on the other hand, to the market over heating because prices are being driven upwards.

Market prices for high quality property have risen to unprecedented heights. One explanation could be the fact that the risk premium for property (total yield minus paid interest) has remained relatively high due to low interest rates for financing. Low interest rates, sometimes even negative, have been common for several years. Despite the reassuring words of the chairman of the European Central Bank, when announcing the end of its bond-buying programme[13], some economists believe that cut backs in this programme will have major consequences. In the meantime, the interest rate on American loans is a few percent higher than that of economic front-runners in Europe and the American central bank (FED) has announced several interest rate-related steps for 2018. Interest rates also appear to be slowly increasing in Europe. For instance, the yield on 10-year Dutch government bonds has been cautiously creeping upwards since January 2018. Exactly the same thing has happened to, for example, the German 'Pfandbriefe' (bonds covered by securities). Finally, the European Union's Anti Tax Avoidance Directive (hereinafter: ATAD) could also play a role: one of the measures is specifically aimed at restricting the deduction of interest costs.

Is the sector prepared for the inevitable turning point in the cycle? Have property firms been wise in their financing and managed to build up enough buffer capital? What will happen if institutional investors restructure their investment portfolios and partly switch to fixed income products? Is the market transparent enough to duly notice the negative signals? Do valuations pay enough attention to potential market corrections? These are relevant questions, which may differ per market segment. For example, the prospects for office and logistical rental appear better than those for retail space, where many retailers are requesting lower rental prices. With this in mind, it is important for the aforementioned public register for transaction data to actually be established. Morgan Stanley Capital International (MSCI) should also resume its quarterly reports about property yields per sub-sector.

12 http://docs.preqin.com/press/Fundraising-2017.pdf
13 https://fd.nl/economie-politiek/1224031/ecb-staat-met-stoppen-van-opkoopprogramma-voor-een-historische-uitdaging

Negative example

Buying own shares has a negative effect

Property company A is listed on the stock market and buys back its own shares to show that investing in one's own shares is better than investing in real estate. This drastically worsens the ratio between equity capital and borrowed capital. The analysts are unanimous: A would have been better off decreasing the loan-to-value ratio. The buy-back programme is regarded as speculative because it is based on an extended property cycle, which will have negative consequences if there is an increase in interest rates. The share price of A suffers a major decrease.

Positive example

Temporary portfolio restructuring

Property company B, which is active in retail property, has decided to sell some of its shops at C locations. The locations in question are expected to offer no returns in the long-term. B thus wants more quality and balance in its portfolio. The first bids were over 30 percent lower than the market value. B then decides to also add better and larger objects to the sales portfolio. As a result, the portfolio is sold for 10 percent below the book value. The loss in value still appears to be significant, but recent valuations showed a further value decrease of 5 percent, with the value expected to decrease further in the future. B's decision leads to a loss in the short-term, but is advantageous because the sales revenue can be invested in property with a lower risk profile.

RECOMMENDATION 1: Duly anticipate the turning point in the cycle

Companies

- Always safeguard the quality of the property portfolio and duly revise the composition of the portfolio in accordance with the desired risk/return profile.
- Make sure the length of financing and accompanying LTV's allows property to withstand another crisis.
- Perform qualitative and quantitative analyses (scenario analyses) and evaluate the effects of a potential new crisis against the existing resistance capability. Assess the scope of capability in relation to business risks. In this case, comply with the provisions in the Dutch Corporate Governance Code.

Investors and sector organisations

- Land Registry and Stichting Vastgoeddata: quickly offer greater transparency into property transaction data, also when it comes to share-based transactions.
- MSCI: resume quarterly reports about property yields per sub-sector.
- Investors: continue to participate in the aforementioned MSCI quarterly reports.

Surveyors

- When determining the exit yield, make sure DCF calculations pay sufficient attention to the changing market, which may lead to significantly different yield requirements.
- Make sure valuation reports also focus on the general sentiment in the market.

Accountants

- Ask for the above mentioned analyses if prospects appear to be worsening.
- Every year, evaluate the company's long-term resilience.
- Remain critical towards valuations, also those involving recent purchases.

Signal 2 | Innovation is leading to profound changes

Due to ever advancing innovation, more and more solutions are becoming available in the field of living, work and transport. These developments are also important for the property sector, particularly because existing property can quickly age from an economic perspective.

Developments in the field of living, work and transport are ever increasing in tempo. At the start of this century, who would have expected electric cars to become so popular or that a platform like Airbnb would start playing such a major role in the rental of private living space?

Property of the future:

- Will be constructed using smart bricks[14], be 3-D printed or assembled using prefab elements.
- Will be rented or sold, financed and registered with the Land Registry using blockchain[15] technology, without a bank, notary or broker being involved.
- Will be fully connected to the internet and feature a digital ceiling.
- Will feature LED lighting and it will be possible to regulate everything using sensors.
- Will be 100 percent energy-neutral due to the energy transition.
- Will not require parking spaces because of unmanned cars.
- Will have flexible walls and thus enable space savings of 50 percent.
- Will be valued using big data.
- Will be subject to automatically settled service expenses.
- Will be managed in a cloud using blockchain technology.
- Will be constructed on a fully circular basis.

Fiction or reality? Only time will tell, but all this technology already exists. This will have major consequences for business models within the sector. The consequences may be encountered in various forms and, for example, lead to another role in the market for brokers, intermediaries and financial institutions. There will be an increase in the rate of economic ageing within existing property, which will be accompanied by the risk of accelerated decrease in values. The preferences of tenants and buyers are changing. This will also erode the financial function within companies and cost arrears will quickly mount up in the property sector - where every tenth of a percent in yield is important - if the financial function is not digitalised in good time.

All stakeholders in the sector must carefully evaluate what this future will mean for them. What consequences will this have for the value of property? Which services will become obsolete and which new types of products and services will emerge? How can vacancy be resolved using platforms and models similar to Airbnb? How will blockchain influence cooperation in the supply chain? What are the consequences of the fact that more and more technology is being purchased by venture capitalists? Who are the new arrivals and which disruptions in the market do they cause?

The biggest challenge involves incorporating the above mentioned developments into the valuation and assessment models used for property. In this case, it would involve adequately and transparently assessing the rate of economic ageing and the investments needed to counter this ageing process. This is not only an issue for property companies and their surveyors, but also for accountants who must assess the value of property during their audits.

14 Smart bricks can be compared to lego blocks and are hollow concrete bricks, which are easy to stack and can be used to incorporate all kinds of features.

15 A blockchain is a database where transactions are permanently registered in chronological order. The transactions in this distributed database are continuously checked using algorithms. Blockchain registers transactions between one user and another and has no central authority. The most famous examples are crypto currencies like Bitcoin.

Negative example

Chief Digital Officer still absent

Research by Strategy & Consultancy shows that one fifth of the largest global companies have a Chief Digital Officer (CDO), of which 60 percent took up their roles in 2015 and later. However, the property sector is absent from the list of sectors where over 3 percent of companies have a CDO. The term 'digital strategy' is also rarely encountered in the annual reports of property companies.

Positive example

Intelligent use of new technology

Property investor C and fintech start-up D use blockchain technology to make property investment accessible to all Dutch residents. C and D start a joint pilot project. The technology helps shares in property investments to be traded easier, faster and cheaper. Participants can also sell small pieces of property to one another, without the involvement of notaries or other intermediaries.

RECOMMENDATION 2: Start working with innovation

Companies

- Develop a long-term strategy concerning innovation and digitalisation and make it a fixed part of the boardroom agenda. Make sure budgets take into account investments needed for implementing new technologies and appoint a chief digital officer.
- Establish partnerships and start technology platforms to offer solutions for new developments like blockchain, artificial intelligence and big data.
- Estimate the consequences of the energy transition for existing property and bear them in mind when purchasing or developing new property.

Surveyors

- Make sure valuation models pay explicit attention to the consequences of innovation, sustainability and digitalisation on the value development of existing property. Develop accompanying KPI's. In this regard, also make a transparent estimate of investments that will be needed in the future.

Accountants

- Focus on innovation and digitalisation in the management letter: on the one hand, as a solution for identified loopholes in internal controls and, on the other hand, to determine how the company has responded to the above mentioned recommendations.
- Evaluate whether new developments could present a threat to continuity.
- Determine whether valuation reports have also taken into account the consequences of innovation and digitalisation on the value development of existing property.

Signal 3 |
The property sector is also a target for cyber crime

Cyber crime is a worldwide phenomenon. All kinds of actions are possible, which includes crashing networks or taking control of hardware. Due to their increasing reliance on IT systems, property managers would do well to invest in cyber security

Cyber crime, the counterpart of cyber security[16], has become a flourishing business. Rogue organisations are earning a lot of money by hacking organisations. Crypto-ware attacks involve criminals taking control of computers remotely and then encrypting the files. They only allow the victim to access these files once a certain amount of money has been paid, with the risk that files may still remain encrypted after payment. Phishing involves sending specific e-mails in an attempt to extract confidential information from employees. DDOS attacks (Distributed Denial-of-Service) are also common and are aimed at crashing networks by overloading them.

Cyber attacks can have far-reaching consequences. Not only due to the direct damage caused during the hack itself, but also due to the indirect damage. It is no longer a question of whether you will be hacked, but when and how often. There is no such thing as absolute security. Organisations must become digitally resilient.

Due to increasing reliance on IT systems and the internet, property companies could encounter cyber attacks with increasing regularity. It is important to be vigilant and establish effective measures with regards to prevention, detection and response. Employees often tend to be the weakest link in the security chain.

In addition, property companies possess large amounts of personal data, like that of current, past and potential tenants who fall under regulations concerning the processing of personal data[17]. Stricter requirements are being established when processing this data, while concerned persons are being given more rights to access their data. Failure to comply with laws and regulations can lead to large fines. Smaller companies are struggling with this because they do not possess appropriate expertise in this field.

It is thus very important for property companies to give cyber security the same priority as physical security. Cyber attacks on property companies can come in all forms:

- Disrupting or taking control of systems used for security and management purposes.
- Locking people inside or outside.
- Unlawful access by unauthorised persons.
- Unlawful access to data about organisations, employees and tenants.
- Deliberate modification of data.
- Theft of confidential information (data leaks).

Cyber security is not only an issue involving the primary processes of property companies. The role played by management is crucial. Besides serving as role models, management must also set the right tone. This will help to improve awareness among employees and create an atmosphere where people address one another about potential risks. Appropriate behaviour must be positively stimulated. The management must continuously test, measure, evaluate and improve their company's culture and conduct in the field of cyber security.

16 NBA Public Management letter about cyber security - From hype to policy. (May 2016)
17 General Data Protection Regulation (GDPR) which came into effect on 25 May 2018

Negative example

Insufficiently secure software

Property company E operates a large number of car parks. E is then held to ransom by criminals using ransomware. Visitors cannot leave the car parks in their cars because it is no longer possible to pay with their cards. This results in large queues. E must send engineers to the concerned car parks to reinstall software used in the payment terminals. E had actually failed to formulate a detailed recovery plan, which contained instructions about appropriately responding to ransomware.

Positive example

Effective cyber exercise

Property company F organises a Cyber War Game. The management of F faces a simulated cyber attack, including the accompanying frenzy, like uncertainty about the cause and phone calls from journalists. It is a very useful exercise. The game is used to expose all missing links in incident response processes. For example, it appears that the required decision-making authority has not been properly organised. The game allows management at F to implement various improvements that will better prepare F for a real cyber attack

RECOMMENDATION 3: Take cyber security seriously

Companies

- Inventory and analyse the risk of cyber crime and include the intended measures in the risk management system. Monitor the effectiveness of these measures and hire professional hackers to test security from time to time.
- Management should set the tone when it comes to cyber security. Test, measure, evaluate and improve culture and conduct relating to cyber security. Make sure employees receive adequate training and information.
- Put in place a recovery plan against cyber crime, including an incident response process and a communication plan. Regularly update this plan.

Accountants

- Regularly remind executive directors about the risks of cyber crime and make recommendations needed to reduce these risks. When doing so, use the recommendations in the NBA Public Management letter about cyber security[18].
- Take into account the potential consequences of cyber crime when evaluating the continuity of automatic data processing and operational management. Pay specific attention to the adequacy of the recovery plan, which includes performing tests to see how the plan works.
- Make sure there is enough cyber know-how in the audit team.

18 NBA Public Management letter about cyber security - From hype to policy. (May 2016)

Signal 4 | Outsourcing increases susceptibility to fraud

Property companies are outsourcing more and more support services to third parties. However, reductions in costs and improved efficiency are also accompanied by increased risk of fraud because control measures actually take place outside the company.

The outsourcing trend actually started in the property sector a few years ago. IT services, property and asset management, portfolio management, lease and risk management and compliance are examples of services that can be outsourced individually or as a package. Many property companies now employ relatively few people because most services are carried out by third parties. Such companies are becoming increasingly prevalent as new players - who do not possess their own property platform - enter the market.

There is also a downside to outsourcing. How can risks be managed if the concerned processes are partly located outside the company? Can behaviour and integrity codes also be imposed on external service providers? How should this be arranged and how can compliance be safeguarded? In this case, the often limited size of the outsourcing property company is a complicating factor.

A number of malpractices have been encountered in the property sector, which could be attributed to collusion. During outsourcing, this involves two or more people - who originate from the outsourcing company and the service provider - unlawfully serving each other's interests at the expense of the respective companies' employees. This can, for example, involve bribes and the allocation of jobs to acquaintances. It can also involve artificial constructions where work is assigned to companies that are (indirectly) owned/controlled by one of the parties and/or people close to the parties, as well as other forms of mutual favouritism. This can also include connections with organised criminality, which may also involve money laundering. Besides the direct negative financial consequences, such collusion does not help the reputation of the involved companies and the sector as a whole. Some of the mentioned malpractices were also reported in the press and had considerable consequences.

Collusion is difficult to detect because it involves abusing the division of functions, which is not always present in smaller companies. Nonetheless, reconstructions of various fraud cases show that fellow employees, who worked close to the fraudsters, had actually noticed abnormalities. So why did people not raise the alarm sooner? This can often be attributed to culture and conduct within the company. With this in mind, soft controls - the intangible side of risk management - have an important role to play. Addressing one another about behaviour, reporting noteworthy issues, sharing dilemmas and offering resistance are important factors, also if a superior is involved.

Negative example

Overly friendly with the supplier

An employee at property company G regularly goes drinking with an employee from service provider X, who has been outsourced certain services. Various colleagues think the relationship appears to be very friendly, but no one raises the issue. It later transpires that G has been financially disadvantaged, which includes charging excessive prices and awarding assignments to companies that were in fact owned by these employees.

Positive example

Outsourcing under control

Property company H has outsourced its property management to service provider Y and, in the interest of fraud prevention, decides to examine all outsourcing procedures. H also organises behaviour and dilemma training, which is partly aimed at identifying and discussing signals of potential fraud. Finally, H talks to the property manager about codes of conduct and the possibility of the accountant issuing an NBA Standard 3402 type 2 assurance report about the quality of parties that are awarded outsourcing assignments.

RECOMMENDATION 4: Create an inventory of fraud risks when outsourcing

Companies
- Clearly incorporate soft controls within the internal control process and get the internal audit department to regularly examine the effectiveness of these soft controls.
- Organise fraud prevention workshops, dilemma training and periodic surveys among employees. When doing so, also pay attention to the tone at the top of the organisation.
- Invest in effective assignment allocation. For example, by requesting Standard 3402 reports and periodically checking if requirements in the outsourcing agreement (service level agreement) are being met.
- Impose the in-house code of conduct on parties that are awarded outsourcing assignments. Demand that attention is given to incident management and periodic rotation of functions.
- Establish a monitoring or integrity commission within the organisation, which is responsible for ensuring compliance with the above mentioned recommendations.

Sector organisations and the government
- Work together with the rest of the sector to restart the debate concerning integrity.

Accountants
- Specifically pay attention to third-party outsourcing when identifying fraud risks.
- If relevant within this risk analysis, evaluate to what extent the company is meeting the aforementioned recommendations.

NBA
- Expand Standard 3402 to include assessments concerning internal controls for non-financial processes and soft controls.

Signal 5 |

Homes are becoming more like an investment

Scarcity in the housing market in certain parts of the Netherlands is leading to excessive increases in sale and rental prices. This is causing the market to come to a standstill; sellers first want to buy a new home before they sell their existing one. This negative effect is amplified because an increasingly diverse range of property investors can now be found in the housing market.

The Netherlands is subject to a shortage of affordable rental and owner-occupied homes, particularly in the large and medium-sized cities (the so-called G32 municipalities). It is estimated that the shortage in affordable rental homes will rise to 200,000 in 2018. This scarcity continues to increase because the number of households is growing faster than the number of homes. Investors say the shortage could even amount to 500,000 rental homes by 2040[19]. Besides being a social problem, this will also have an effect on price development in the property market. Attracted by this scarcity and the increase in rental prices caused by it, more and more investors - private parties and venture capitalists in particular - are focussing on the residential market. Investing in owner-occupied homes, to then let them out, has become a new form of investment. This is leading to further increases in house prices, unaffordable rental homes and investment yields that are heading towards an all-time low. Renting is becoming a decreasingly affordable alternative to owner-occupied homes. According to the statistics of the NVM, the average rental price of available rental homes and apartments above the liberalisation threshold increased by almost 20 percent in four years' time as of 2014. During the period 2013-2016, rental prices increased faster than the prices of owner-occupied homes, while this was actually the opposite in the period 2014-2017 (when prices for owner-occupied homes increased by 24 percent). It is worth mentioning that there are major regional differences. For instance, rental prices increased a lot faster in the Randstad, whereas Amsterdam realised an increase of almost 10 percent in 2017 alone. Here are a few underlying causes for scarcity in the residential market:

- A halt in construction activities during the crisis. Municipalities followed suit, even though demographic developments showed that demand for homes would remain high. Only now are municipalities starting to actively implement policy aimed at investors, particularly in the major cities.
- Dutch investors in the property market were late in responding, after foreign investors became active in the Dutch housing market immediately after the crisis.
- Because housing associations are now subject to new laws and regulations, they have been reluctant to start new-build projects in the open sector.
- Underestimation of demographic trends, while the market had long since shown an increasing number of one and two-person households, with people relocating from the suburbs to the city.

Due to the mandatory separation between services of general economic interest (DAEB) and commercial services (non-DAEB), many housing associations have decided to mainly focus on their DAEB activities. They are shying away from building homes in the middle segment and are restricting themselves to constructing social homes, while the government says there are already enough social homes[20]. In addition, municipalities like Utrecht and Amsterdam are establishing more and more requirements for rental homes and are forcing developers to make rental price agreements that can run for 25 years.

The mentioned developments also present a risk of unrealistic price forming in the commercial property market, which will dissipate once there is equilibrium between demand and supply. The negative consequences will be felt by property investors, home owners and financiers.

19 https://www.cobouw.nl/bouwbreed/nieuws/2017/04/beleggers-500-000-nieuwe-huurwoningen-nodig-101248088
20 https://fd.nl/economie-politiek/1184292/blok-spoort-corporaties-aan-om-veel-meer-woningen-te-verkopen-aan-beleggers

This paints a controversial picture: persistent scarcity result in the existing status quo, while attempts to resolve it can actually lead to (substantial) value decreases. This effect will be intensified once interest rates start rising again.

This is precisely why there is great need for structural building and home management in the Netherlands, which goes further than the recently published Nationale Woonagenda (National Housing Agenda)[21].

Negative example

Insufficient political support

In balance, most transactions between investors and housing associations do not lead to an increase in housing stock. Municipality U provides the ground, while housing association V and developing investor W try, by way of mutual exchange, to establish a construction that helps to increase the net housing stock. The aim is for W to build on the ground made available by U, with the new-build then being transferred to V in exchange for existing homes that lie outside V's core area. Everyone is enthusiastic, even the government, but the plan is eventually rejected by the council because insufficient attention has been paid to gaining political support.

Positive example

Attention to one another's interests

Municipality Z is about to collaborate with construction and investment parties to realise more homes in the middle segment. To start this partnership, Z organises an initial collaboration meeting. During an open dialogue, developers, investors and Z try to find solutions and make agreements while paying attention to one another's interests. Question like those shown below are placed on the agenda: For which income category are the homes being realised? How long will they be rented in the middle segment? How will rental prices increase in the future?

RECOMMENDATION 5: Address scarcity in the residential market

Companies
- Use the funds available at pension funds and insurers to invest in Dutch homes.
- Be alert for unrealistic price forming and the consequences for future valuations of existing property.

Housing associations
- Try to collaborate with investors, for example, by way of exchange.
- Make better use of opportunities offered by the Woningwet (Housing Act) for the development of homes in the middle segment.

Municipalities
- Accelerate the process of allocating construction locations inside and outside urbanised areas.
- Evaluate the effects of the current liberalisation threshold.
- Set up planning permission policy in a manner that allows procedures to be completed more efficiently. When doing so, collaborate with other municipalities and implement a common land policy so houses can be realised on suitable priced plots.

Government
- Move away from pro-cyclical construction and take control of housing policy via a structural building and housing vision for the Netherlands. Explicitly involve investors, financiers and infrastructure and encourage partnerships when doing so.

21 Nationale Woonagenda 2018-2021 (letter Minister Ollogren 23 May 2018).

Credits

In the NBA Sharing Knowledge policy programme the expertise of accountants is collectively applied to signal risks early in social sectors or relevant themes. In doing so the emphasis is on governance, operations, reporting and audit. The NBA has used this public management letter (PML) to present five signals for the commercial property sector. The sector is the 20th topic to be selected by the Identification Board of the NBA. A working group of public and government accountants in the sector gathered anonymised findings and discussed them. This was then discussed at a sector meeting with stakeholders.

The Identification Board gauged the signals from a social perspective and applied a social assessment to the signals. Stakeholders in the sector were willing to respond to the PML. Coordination and final editing was provided by the Sharing Knowledge programme team.

Further information

A public management letter is one of the publications issued by the Sharing Knowledge policy programme. Open letters and discussion reports are also released. The NBA has released the following publications:

- 2017: Housing associations
- 2016: Cyber security, Energy sector and Introducing new laws
- 2015: Curative healthcare and Hospitality
- 2014: Life Sciences and Banks
- 2013: VET colleges, Risk management and Transport & Logistics
- 2012: Municipalities, Tone at the Top and Charities
- 2011: Commercial Property, Pensions and Greenhouse Horticulture
- 2010: Insurance and Long-term Care

All publications are public and are intended for a wide audience.

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The last five years NBA published sixteen Public Managementletters (PML's) concerning specific sectors or themes.

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