# Snakes and Ladders in the Commercial Property Investment Market – November 2013

**A paper presented by Anthony Ratcliffe of Ratcliffes to the Dentons Property Seminar at the Rubens Hotel, Buckingham Palace road, London SW1 on Thursday, 28th November, 2013.**

Good morning to you all. My paper, 'Snakes and Ladders in the Commercial Property Investment Market', will explain the strategies we adopt when acquiring investment properties, either for our Private Clients or Syndication, show how we assess the properties, and comment on current market conditions.

My Firm has specialised in advising Private Clients since **1970** and in syndication investment since **1990**. We eschew Institutions as Clients, preferring to buy from them, acting against them, rather than for them.

Why do we have this preference? Because with our Private Clients we build lasting relationships based on mutual respect and loyalty. In many instances we are now working with the next generation, advising the sons and daughters of our original Clients.

Most of our Clients have made their fortunes in other areas and have little knowledge of commercial property. Some think that it is not too different from residential property, where, as house owners, we are all experts! Is commercial property investment as "safe as houses"? No, because the bedrock of investment property is occupational demand and having somewhere to live will, and should always, take priority over having somewhere to work. Everyone's principal investment should be the house in which they live, with other asset classes considered thereafter. Nevertheless, the risk/reward ratio for commercial property is highly attractive by comparison with other asset classes.

A graphic illustration of the difference between commercial and residential property investment is that in a residential investment if a **tap** leaks, it is the Landlord's problem, whereas in a commercial property investment if the **roof** leaks, it is the Tenant's problem.

Although the British residential property market has seen spectacular capital growth over the last twenty years, appreciating by a national average of over **300%**, residential income is typically poorly covenanted, sporadic and uncertain. Commercial income, on the other hand, should be well covenanted, regular and certain.

A buy-to-let house or flat will usually let to a private individual, on an Assured Shorthold Tenancy for a maximum period of a year, although renewable. After the Tenant vacates it may well have to be redecorated and perhaps repaired. Typically there will be a few weeks, or even a month or two, without rental income, until the dwelling is relet and that cycle can repeat on an annual basis. Net rental income can therefore be as low as **70%** after costs and deductions.

A prime commercial property investment should be let to a major organisation who offers a strong covenant. The Lease will be for five or ten years and all repairs will be the Tenant's responsibility. Unless the Tenant goes bankrupt a loss of income will only arise at the end of the Lease, and only then if the Tenant does not wish to renew.

The asset class of commercial property investment has distinct characteristics with advantages and disadvantages.

The advantages are:

**That** it is a highly sophisticated market in which British property advisers have honed their skills to such a level of competence that they have successfully exported them worldwide.

**That** prime Commercial properties are let to major Organisations on long full repairing Leases with an upward only rent review structure thus guaranteeing a minimum income flow throughout the term of the Lease.

**That** the Tenant carries full responsibility for the repairs and maintenance of the interior and the exterior of the building.

**That** with minimal deductions, around **95%** of the rental income should be net to the Landlord.

**That** it is a counter-cyclical asset class. Commercial property tends to do well in years when the stock market does not, and vice versa. For example, in **1992** property returned minus **1.7%** and the stock market returned **20%.** A decade later in **2002** property returned **9.6%** and the stock market returned **minus 25%**. In **2011 –** not the best of years for property, the class still returned **7.6%** and the stock market returned **minus 6.7%**.

The disadvantages to the asset class are:

**The** high transactional costs, of which Stamp Duty at up to **4%** on a purchase is the greater part.

**The** requirement for substantial capital investment.

**The** fact that in a weak market a sale can be a slow and difficult process.

I often tell my Clients that commercial property suffers from the Cold Custard Syndrome. Why is commercial property like cold custard? Because it is lumpy and it is not liquid.

An Investor can buy shares in a leading plc for a few thousand pounds, but a property let to a leading plc will cost several hundred thousand pounds – this is the lumpiness of property as an asset class.

If the Financial press over the weekend is bearish on the prospects for shares, a nervous Investor can liquidate his share Portfolio first thing Monday morning and be back in cash some 10 days later. If the property market starts to slide the sale process can take several months, perhaps even a year or more – this is the lack of liquidity.

A Client once told me 'I am fed up with getting **20%** in the Stock Market one year and losing **10%** the next. Commercial property gives me a steady **7%** or **8%** most years and I know where I am'. Another told me 'The stock market sends me certificates for the shares I buy – but these are just paper. When I buy a property, if I get nervous, I can always go and stroke the bricks'.

The total value of all **27 million** residential addresses in the UK has reportedly risen to **£5.5 trillion.** By comparison, commercial property is a smaller asset class with a value circa **£2 trillion.** Furthermore, of this **£2 trillion**, less than half is investment grade, so in those years when commercial property becomes the investment panacea it is not difficult to overheat the market, as we saw in the last decade, until the **2008** crash.

The Investment Property Databank has reported commercial property market returns over the last four difficult years of **-22%**, **2.2%, 10.6%** and **7.6%** respectively.

As the turmoil in the financial markets washed over to the commercial property market, mortgage finance became less available and then non-existent. This, together with the economic recession and a weakening of confidence combined to bring about the massive crash in values. Liquidity is beginning to return and I consider prime property to presently be about 2**0%** off the peak and secondary property to be **50%** or more off the peak.

2013 is seeing a return to capital value growth as rental values have stabilised and started rebuild. Although yields rise and fall according to Investor demand, it is the assured long term income stream that makes commercial property continue to be a well regarded investment class.

Commercial property falls into three categories - retail, office and industrial. Sub-categories comprise out-of-town retail, leisure and social - such as nursing homes, medical centres and student accommodation.

We specialise in just two - high street retail and prime offices and invest approximately **90%** retail and **10%** office.

Why do we ignore the other categories? Because we do not understand them, or we do not trust them, or a combination of both.

Why do we buy **9** times more high street retail properties than offices? Because offices outside Central London do not perform - rental growth in offices from **1990** was stagnant for **15** years, at minus **2%**. Retail on the other hand saw average rental growth between **1990** and **2005** of **2.7%** per annum, before the crash brought the peak values of **2008** back to **2005** levels.

Why do we buy any offices? Well, we buy the no-brainers; prime buildings let to undoubted covenants, such as the Government on long Leases, but only when the market dips and we see an opportunity to buy in a trough so that we can sell out later in a peak.

What are the characteristics of a good commercial property investment?

<u>First</u> - Location – a cliché but still an imperative. You may buy a well-let property, but if the location is poor and the Tenant fails, or fails to renew his Lease, you will struggle to relet and the rental growth will be poor or non-existent.

<u>Second</u> - Accommodation – the property must provide well arranged and flexible accommodation, capable of housing a wide range of occupiers.

<u>Third</u> - Title & Tenure – the property must have a clean and marketable title and the Lease must be well drawn to provide the Landlord with minimum responsibility and the Tenant with the maximum liability.

<u>Fourth</u> **-** Condition – the property should be in a good state of repair and to ensure this a prudent buyer will invest in a thorough building survey.

<u>Fifth</u> - Covenant – the property should ideally be let to a strong company who will be regarded as undoubtedly capable of paying the rent, meeting the Lease obligations and keeping the building in good repair for the term of the Lease.

Note that I place covenant strength last in the order of precedent. Many Investors make the mistake of placing this first. They pay excessive prices for properties let to Banks believing these to be the best property investments, because the Tenant is unlikely to go broke. They completely overlook:-

That the building might only be suitable for occupation as a Bank,

That Banks are reducing their High Street presence and may not renew the Lease upon expiration,

That if the building returns to the Landlord, considerable expenditure may be necessary to render it suitable for alternative occupation.

Investors will compete to buy a Bank investment for a **5%** yield, when the W H Smith shop next door can be bought for **6%**. Unlike the Bank, should Smiths vacate, the shop would suit a host of alternative occupiers, with minimal alteration.

But has retail shot its bolt? We have seen a considerable number of failing retail chains and depressed consumer demand; as well as unscrupulous multiple retailers, entering into a Voluntary Administration arrangement, only to swiftly emerge with their profitable shops, leaving the loss-makers with the Landlords. This worries the market, but also leads to opportunities to buy more cheaply to hopefully resell on the rebound. In the words of the old adage - “Buy from the frightened and sell to the greedy”.

The retail world is always evolving and reinventing itself and with on-line penetration now at **17%** of the retail cake, demand for shops nationwide has reduced significantly. Interestingly, the on-line percentage of the retail market in the USA is still only **9%**, whilst the UK’s share of the global on-line market is an astonishing **11%**, a reflection of our international reputation for retailing and strong customer protection regulation. So whilst on-line retailing weakens the High Streets, it is also building a huge export business to the benefit of UK plc.

In defence, we only buy prime retail assets in historically strong and prosperous towns. We like opportunities where the Tenant is a fading retailer. If we can obtain vacant possession of the property we can improve the building and relet at a higher rent to one of the more vibrant retailers - replacing Baxters Butchers with Boots Opticians, Currys with Costa Coffee, Mothercare with Mountain Warehouse, Sketchleys with Specsavers, Woolworth with Wilkinsons, and so on.

Property selection is key. If it is a prime location in a vibrant town, in normal market conditions, tenants will compete for it. Whilst retail distress has been bad in the High Streets, it has been far worse in the shopping centres, where the asset managers had vigorously massaged rents to the point that, with high centre management and service charges, and increased rateable values, the retailers struggled to make a profit margin. By contrast, High Street rents and rateable values have been be more realistic and competitive, and centre management and service charges do not apply.

Commercial property works on a five year cycle. Why? Because the rent reviews occur every five years. You will be aware of the recent debate over the abolition of upward only rent reviews. Our industry had to work hard to persuade the blockheads in Government that the abolition of upward only rent reviews would do much more harm than good - an argument we seem to have won, at least for the present, although the trend to shorter leases is weakening the strength of the upward only rent review.

We tell our Clients not to fall in love with their properties. In the time of food rationing during the Second World War, the Black Market trader went home to find his wife opening a tin of sardines for their tea. “Why are you giving us sardines, woman?” he said, “Well, we’ve got cases of them in the back room,” she replied. “Yes, but these sardines are for trading – not for eating.” Most properties are like sardines; they should be bought to be traded. We buy with a two to five year view and once we have taken the property to a peak of value it is resold. We then look for a replacement investment where we can work it to add value for our Investors before selling on again.

We like to buy a property before its next rent review, provided that we are confident that we will secure an uplift in the rent.  When we have done that, given reasonable investment market conditions, we will sell.  To hold a property passively for the next rent review five years hence is not our game.  That is for the Institutions and, as I explained earlier, they are our prey.

In **1990** after several boom years the commercial property market collapsed and prices fell to post-war lows.  Our Clients were not in great distress, for the quality of the properties we had bought for them was prime and the strength of the Tenants ensured that the rents would be paid, but they were sitting on a lot of property that, if sold, would have resulted in substantial capital losses.  The only sensible strategy was to hold on until the market recovered, a year or two hence.  But the recession of the early **90's** was so deep, that it was to be nearer four years before a full recovery was seen.  In that period prime property investments were available at the cheapest prices we had ever seen.  We needed new Clients to help us take advantage, as our existing Clients could only buy a little of this stock, whilst they awaited the recovery in value of their investment portfolios.

It was then that Ratcliffes, pioneered the concept of tax-transparent property investment syndicates.  For the first time, smaller investors could be joined together to purchase some of the larger choice property assets which were available at such attractive prices.

Our first syndicated investment was acquired in **1990** - a shop bought for **£250,000**, with **£150,000** of mortgage and **£100,000** of cash, arranged in **10** shares of **£10,000** each.  Ratcliffes took one of the shares to show our syndicate investors that we were happy to put our money where our mouth was.  The concept immediately proved attractive and we bought a lot of property up to the market recovery in Spring **1994**.  Everything was then sold out, achieving an extraordinary averaged return that year of **84%** for our early syndicate clients.  We now have over **300** syndicate Investors registered with us, over **200** of whom are active and invested across a number of our syndicates, some **40%** doing so through their SIPPs or other pension structures.

To date we have purchased and syndicated over **225** properties with a total value in excess of **£325 million** and have resold over **150** properties in **122** syndicates. We presently manage some **75** properties with a value circa **£150 million**. Our largest syndicated property purchase to date was at just under **£27 million**, but a recent purchase was at **£400,000**, syndicated in **8** shares at **£50,000** each..

Our audited investment returns, which can be seen on our website **(www.ratcliffes.com),** confirm that in the first **20** years since we pioneered tax-transparent syndicates, no Ratcliffes' syndicate made a loss. Our average return on capital employed to **December 2011** was **85.15%,** on properties owned for an averaged **3.49 years**. For the twenty years between **1991** and **2011** our averaged annual compound return was **25.53%**.

By comparison, over the same twenty one year period the IPD Index for the UK Commercial Property Market showed an averaged annual return of **8%** and The FTSE All Share Index an averaged annual return of **6.34%**. I repeat, our Syndicates' averaged annual return was over **25.5%**. Sadly, our twenty one year unbroken run of **100%** profitability came to an end in **2012**, when the impact of the recession and the mortgage famine, forced some distressed sales and lender handbacks. But, in eleven of the last twenty one years, property has outperformed equities.

As the level of risk in the Stock Market is so much higher, I believe that returns on equities should be at least double those from commercial property. The loss of all or most of one's invested capital in the stock market is all too possible – Enron, Lehmans, Northern Rock and Woolworth are but a few recent examples. The loss of one's entire capital in a commercial property investment, where ungeared, is a remote possibility. The Tenant might go broke, but the Landlord can relet and the land and the building thereon will continue to exist and hold value. It is my opinion that throughout the **1990's,** equities and property were fundamentally mispriced - equities were grossly over-valued and properties were seriously under-valued.

In the **80's** Investors bought property as a hedge against inflation; in the **90's** they spurned it to ride the dot.com rollercoaster; and in the early **00's** they returned to property for its solid income characteristics in a low inflation environment. The **2008** crash simultaneously decimated both markets – property fell by **22%** and the stock market by **33%.**

I will conclude with our somewhat "tongue-in-cheek" Ratcliffes' Rules:

1. When it is impossible to buy anything it is time to sell everything. When it is impossible to sell anything it is time to buy something.

2. Do not buy a property to absorb available cash – this is putting the cart before the horse. Buy a property because it is too good an opportunity to lose and then find the money.

3. Do not be seduced by covenant. It is the least important factor when evaluating an investment. The first consideration must be location, which cannot be improved. The second is the accommodation, which must be flexible. The third is good Title and Tenure. The fourth is the condition of the building. The last and least important consideration is the covenant strength. Defects in all of these can be rectified, with the exception of the location.

4. Do not borrow more money to fund a purchase than the rental income will comfortably service.

5. Try to add value whilst the property is in your ownership. Ideally, the property should be enhanced in some way before it is resold.

6. Remember that not only does the property investment market have its peaks and troughs, but so do individual property investments. These closely follow the quinquennial rent review cycle. The purchase of a reversionary property a year or two before the rent review should, following a successful rent review, provide good capital growth.

7. Do not under-pay for an over-let investment. It is better to over-pay for an under-let investment.

8. Do not hold a property investment once it is ex-growth. Trade on when its potential has been exploited.

9. Lastly, break any and all of these rules if the deal feels right!

Investors have worked hard to make and save their monies. They should place it where they feel comfortable, either because they understand the asset class, have confidence in their Advisers, or preferably both. That holds true whether they invest in property, equities, gilts, antiques, fine wines or classic cars. Investments should provide performance, satisfaction and enjoyment, but not sleepless nights.

So, with a little bit of luck, and a lot of good advice, it is possible to climb the property investment ladders and avoid the snakes!

Thank you for your attention.



**Ratcliffes**
**Chartered Surveyors**
**55 South Audley Street**
**Mayfair**
**London**
**W1K 2QH**
**Tel 020 7629 4036**
**Fax 020 7408 0499**
**www.ratcliffes.com**