What do Private Investors Require?

A paper presented by Anthony Ratcliffe to the 2nd PPI Property for Private Investment Conference at the Institute of Directors, Pall Mall, London on Thursday, 7th July 2005

Good morning to you all. My paper will attempt to answer the question 'What do Private Investors Require?'

I am sure you are familiar with the old adage "Buy from the frightened to sell to the greedy".

When Private Investors are referred to us we find that they are rarely greedy but they are often frightened, or at the least, apprehensive. Many of them have experienced poor results in other areas of investment – the vagaries of the Stock Market – the horrors of Lloyds – the incompetence of previously revered Institutions, such as Equitable Life. They are not looking for outstanding investment returns. They have had those promised in other asset classes and been disillusioned. They are looking for safety, for the preservation of their capital, and a fair rate of return upon it.

One of my Clients 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 ultimately these are just paper. When I buy a property, if I get nervous, I know I can always go and stroke the bricks'.

My firm has specialised in advising Private Investor Clients for over 35 years. We eschew Institutions as Clients, preferring to buy from them and sell to them on behalf of our Private Clients, 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 several instances we are now working with the next generation, advising the sons and daughters of our original Clients.

Many of our Private Investor Clients have made their fortunes in other areas and were unfamiliar with the world of commercial investment property. Some thought that it is not too different from residential investment property, where, as house owners, we are all experts! Is commercial property investment as “safe as houses”? Not quite, because the bedrock of investment property is occupational demand and having somewhere to live will 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 of commercial property is highly attractive by comparison with other asset classes.

To illustrate the vast gulf between commercial and residential property investment; in a residential investment if a **tap** leaks, it is the Landlord’s problem; in a commercial property investment if the **roof** leaks, it is the Tenant’s problem.

Residential income is typically poorly covenanted, sporadic and uncertain. Commercial income should be well covenanted, regular and certain.

A buy-to-let house or flat will probably 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.

A prime commercial investment should be let to a major organisation who offers a strong covenant. The Lease will be for ten or fifteen years and all the 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.

It should be borne in mind that 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 UK property advisers have developed 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 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, unlike residential property, 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 **23%**.

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.

A Private 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 Private 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.

Commercial property is a relatively small asset class with a value circa **£600billion** by comparison with a residential property value circa **£3,000billion** and a stock market value currently circa **£1,700billion**. In those years when commercial property becomes the investment panacea it is not difficult to overheat the market, a situation we are now seeing.

Last year the stock market returned **12.8%** and the Investment Property Databank reported returns for commercial property of **18.3%**. Yet these fantastic property returns were achieved in a year when average rental growth was just **2.3%**. This performance was almost entirely based on yield compression. In other words, new money coming into the market to buy commercial property investments and being prepared to bid higher to secure them.

This trend has continued into 2005 but I doubt that in 2006 we will see a further fresh wall of new money entering the market. I think it likely that we will end the year with performance more than halved to a still attractive **8** or **9%**.

When the present heat in the commercial property investment market has cooled we will return to the norm, where property capital values grow as a consequence of rental growth. Whilst yields will rise and fall according to Investor demand it is the assured long term income stream that makes commercial property one of the safest investment classes.

This is why the Private Investor should favour commercial property investment for a substantial proportion of his investment portfolio.

So what should the Private Investor do if he wishes to invest in commercial property?

First, he must consult an expert - this is not an asset class suited to the DIY Investor. That is not to say that, after a few years working with competent Advisers, the Investor could not learn enough to do it himself, but I have been doing this job for over forty years and I am still learning!

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? Simple. Offices do not perform - rental growth in offices has been stagnant for **15** years, at minus **2%**. Retail on the other hand has seen average rental growth since 1990 of **2.7%** per annum.

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 in a peak.

Over the last **15** years, for our Private Client syndicate structures, we have bought and resold **97** retail properties but just **6** office buildings. The offices returned an average **110%** on capital employed, over an averaged ownership period of **5.4 years**, with an averaged annual compound return of **15.8%** - not too shabby.

But our retail investments returned **87%** on capital employed, over a shorter averaged ownership period of only **3.6** years, delivering an averaged annual compound return of **28.2%**. I repeat - a **28.2%** averaged annual compound return on our retail investments, compared with **15.8%** averaged annual compound return on our office investments, a differential of **12.4%** per annum compound.

Nevertheless, considering the negative rental growth in the office sector over the last fifteen years a near **16%** annual compound return is pretty good. How was it achieved? The profits were almost entirely derived from yield compression. In plain English, buying when an opportunity in the market existed at a near **8%** yield and reselling when the market was prepared to buy at a yield near **6%.** It shows you how hard that is to achieve when you remember that since **1990**, of the **103** properties bought and resold in our syndicate structures only **6** were office buildings.

Yet **15** of the largest Institutional Property Fund Managers still hold an averaged **28%** of their property investment portfolios in offices compared with only **27%** in High Street retail properties. Why do they persist in holding a greater proportion of their assets in the poorly performing office sector, rather than in the much better performing retail sector? Their remit is to invest a certain amount of money each year almost regardless of market conditions. An office investment typically requires a larger capital commitment than a retail investment. Buying a large office building is an easier way to place monies and meet annual investment targets.

To my mind that is putting the cart before the horse. Ratcliffes **always** prefer to source a property investment we feel we must buy because of the opportunity it offers. We then sort out the financing for it afterwards. If the deal is right the money will be there.

What are the characteristics of a good commercial property investment?

First - Location – a cliché perhaps but 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.

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

Third - 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.

Fourth **-** 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.

Fifth - 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 stupid prices for properties let to Banks believing these to be the best property investments because the Tenant will not go broke. They completely overlook the facts that

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

b) that Banks are gradually exiting the High Streets and are unlikely to renew their Lease upon expiration,

c) that once the building returns to the Landlord considerable expenditure may be necessary to make it suitable for alternative occupation.

Investors will buy a Bank investment for **5%** when the Burton shop next door can be bought for **6%**. Unlike the Bank, should Burtons vacate, the shop would suit a host of alternative occupiers, with minimal alteration.

But has retail shot its bolt? Today's press contains stories of failing retail chains and depressed consumer demand. We love these scare stories. They give us a chance to buy more cheaply and resell on the rebound. Again - "Buying from the frightened, to sell to the greedy".

The retail world is always evolving and reinventing itself. The constant is the demand for prime shops. We only buy prime retail assets and we like to buy where the Tenant is a fading retailer. If we can get possession of the property we have an opportunity to relet at a higher rent to one of the new vibrant retailers - replacing Sketchleys with Specsavers, Olivers with Ottakers, Powerhouse with Carphone Warehouse and so on.

The property is key. If it is prime the Tenants will compete for it. Much of the current retail distress is not actually on the High Street, but within the large shopping centres where the asset managers have vigorously massaged rents to the point where, combined with high centre management and service charges and increased rateable values, the retailers are now struggling to make a profit margin. By contrast, in the High Street, rents and rateable values remain more realistic 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.

We try to teach our Clients not to fall in love with their properties. In the old Second World War Black Market story, the tins of sardines were for trading – not for eating. 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 Private Clients were not in great distress for the quality of the property we had bought for them was prime. The strength of the Tenants meant that the rents would continue to be paid, but they were sitting on a lot of property that, if sold, would have produced substantial losses. The only sensible strategy was to hold on until the market recovered as it usually would a year or so 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 fantastic 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 existing investment portfolios.

It was at this point that Ratcliffes conceived the concept of tax transparent property investment syndicates. New small investors could be joined together to pick up some of the choice 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 averaged return that year of **112.6%** for our first syndicate clients.

Since **1990** we have purchased over **150** properties in syndicates and have resold over **100**. We presently manage over **50** properties with a value in excess of **£100million**. Our investment returns can be seen on our website **(www.ratcliffes.com)** but I can tell you that in the **15** years since we pioneered tax transparent syndicates; **no** Ratcliffes' syndicate has made a loss, our average return on capital employed is **89%** on properties owned for an averaged **3.9 years**, and our averaged annual compound return for the thirteen years between 1991 and 2004 is over **27%**.

The FTSE Index over the last **15** years has shown an averaged return of **10.56%** per annum compound, but by comparison with commercial property investment, this market is a Casino. The level of risk there is so high that the returns on shares should be at least double those from commercial property. The loss of one's entire capital in the stock market is all too possible – Enron, Marconi and Worldcom are a few recent examples. The loss of one's entire capital in a commercial property investment is a remote possibility. The Tenant might go broke, but the Landlord can relet and the land and building thereon will continue to exist and hold value. I believe 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; in the **00's** they have returned to property for its solid income characteristics in a low inflation environment.

I will conclude with 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 on a purchase than the rental income will service.

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

6. Do 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. Break any and all of these rules if the deal feels right!

Private Investors are investing money they have worked hard to make and save. 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. Their investments should provide performance, satisfaction and enjoyment, but not sleepless nights.

Thank you for your attention.