<u>The Case for Commercial Property Investment</u>

<u>by the Private Investor</u>

A paper presented by Anthony Ratcliffe to the Financial Mail on Sunday
Live Investment Seminar, at the Commonwealth Institute, Kensington High Street,
London, W8 on Friday 31st January 2003.

Good afternoon, ladies and gentlemen.

My paper will be in four parts - the **who**, the **why**, the **what** and the **how**. **Who** should consider investing in commercial property; **why** they should consider investing in commercial property; **what** commercial property to buy and **how** to go about it.

Firstly, **who** should invest - it is a simple answer. **Everybody** - once they have purchased the house in which they live and built up surplus monies for investment. I am afraid that the remaining parts of my paper are a little longer!

Secondly, **why** should we all consider investing in commercial property? 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. Nevertheless, the risk/reward ratio is very attractive by comparison with the other asset classes.

In 1992 property provided a mere **1.6%** return during the year compared with 20.6% return for UK equities. Ten years later in 2002 the Stock Market had fallen for a third consecutive year and by a massive **25%,** whilst commercial property values rose by **12.5%.** The statistics for those two years, a decade apart, demonstrate that the performance of these two markets is often at odds with each other, and serve as a reminder that property does not relentlessly rise in value year after year.

But, over a 1 year, 3 year, 5 year and now 10 year cycle commercial property has out performed equities, gilts and cash. This is perverse for the Stock Market **should** consistently out perform property, gilts and cash because it is much the riskiest of these investment classes. That it has not suggests that the Stock Market has been fundamentally overpriced for much of the last decade and conversely perhaps that commercial property was fundamentally underpriced for much of the last decade.

In the 80's Investors bought property as a hedge against inflation. In the 90's they largely ignored it preferring the risks and rewards of the Stock Market instead. In the OO's Investors have returned to property for its solid income characteristics in a low inflation environment.

Remember that a quoted pIc is ultimately selling its Investors a paper stake in itself; shares can and do melt down in value - sometimes to the point of extinction, as we have recently seen with Cable & Wireless, Enron, Marconi, Mytravel, Worldcom and too many others.

Property on the other hand is tangible - it can be seen, touched, occupied and used. Its value may fall, sometimes drastically, but rarely to the point of extinction, for the building and the land on which it stands will continue to exist. As a Client once told me "I like knowing that I can always go and stroke the bricks!

At last week's Stock Market close, after ten successive falling sessions for the first time in its history, leaving the Index at its lowest level for seven years, the averaged yield of the shares of eight of our leading companies - BP, Barclays Bank, Dixons, GUS, Marks & Spencer, Next, Tesco and Vodafone -was **3.9%.** Bear in mind that there is no certainty that dividend payments will be maintained at these levels this year, as recently demonstrated by Abbey National's dividend cut.

But a commercial property let to any of these companies can be presently purchased to show a yield of around **7%**. So we can achieve a near doubled increase in our yield from **3.9%** to **7%**, be secured on a long term Lease for **10** to **15** years and be buttressed by upward only rent reviews. Furthermore, rent is a prior charge and excepting bankruptcy or the expiration of the Lease, the income is secured and cannot fall. Remember that when a Company is in trading difficulty it **must** pay its rent to stay in business, but the Directors can always cut the dividend.

A specific example is even more enlightening. At last week's close, Vodafone's shares were **114p,** down from their historic high of around **485p,** a value loss of more than **75%** over the last three years. But even at this price the yield is just **1.3%.** Last year my firm sold a building let to Vodafone with 13 years remaining on the Lease, to show a yield of **7.4 %.**

Where would you rather have your money - in the shares for an uncertain **1.3%** or in the property for an assured **7.4%?**

So why is it that a commercial property investment is typically priced at a level which offers a **200%** plus higher return in rental income from say Dixons, Next or Tesco, than the dividend income from these same companies?

Well, property does have its drawbacks, which I sometimes describe as **The Cold Custard Syndrome**. What characteristics does commercial property have in common with cold custard? The answer is that they are both **lumpy** and they are **not liquid.** A Private Investor can invest in the shares of a leading company for a few **thousand** pounds, but to invest in a commercial **property** let to that leading company, a few **hundred** thousand pounds would be needed - this is the lumpiness of property as an asset class.

If the Financial Mail on Sunday 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.

So what is an appropriate discount be for those two acknowledged drawbacks? A doubled or tripled yield at around 7% seems most handsome compensation for property's perceived disadvantages.

Thirdly, **what** commercial property should be considered for investment. There are four sectors - retail, office, industrial and leisure - all with their own characteristics, advantages and disadvantages.

Retail property can offer strong tenant companies, smaller lot sizes, and a low obsolescence factor; the land being usually a higher proportion of the value than the building. This means it is cheaper for the Landlord to refurbish or redevelop the building. Its disadvantages are that it is proportionately more expensive than the other sectors, thus offering a lower yield, and that it is consumer linked, so that it does well when the Country is doing well and badly when it is not, and so is less successful as a defensive asset.

Offices can offer strong tenant covenants, but at much larger lot sizes and with a high obsolescence factor, the building usually being much more expensive than the land. Refurbishment or redevelopment costs are therefore high and office rents tend to be less reliable in terms of rental growth. They have not performed well over the last decade, rents being much the same now as ten/twelve years ago. Nevertheless, an expanding Government sector needs office accommodation to house its burgeoning Civil Service, and Investors will always be keen to purchase property let to Her Majesty's Government, perhaps the best quality covenant in Europe today.

Industrials offer mixed covenants and again will require a larger investment than retail to secure quality. This has the highest obsolescence factor; intensively used factories and warehouses require full refurbishment or rebuilding every 20/30 years, but the buildings are the cheapest to replace, and yields in this sector are higher than the rest.

Leisure can offer good covenants and often longer leases than the other sectors, for it is the newcomer to the list. Valuation at rent review can be difficult because of the immaturity of the market but this sector is probably the closest to retail in characteristics of obsolence, lot size, and yield.

When considering an investment in any property, the over-riding consideration **must** be location. You can remedy everything else - poor condition, weak Tenant, unfavourable Lease terms, but you can do nothing about the position.

Too many Investors look **first** at the strength of the Tenant, or “the Covenant" in property speak, and this is a mistake.

Private Investors over the last few years have paid excessive prices for High Street Banks in small town locations reasoning that they would rather own the bank and earn a **6%** yield from the rents, than have their money inside it earning less than **3%.**

My concern here is that the Banks have raised cash on their freeholds by selling and leasing back, usually at full rents leaving little or no growth at the first rent review 5 years later, and often with an intention to vacate the building at the end of the Lease or perhaps sooner.

The Investor may then have a vacant building in a retail position, but physically unsuited for retailing without expensive works of conversion. A residential use for the more secondary locations may be possible but will need planning permission and again expensive works of conversion or re-development. The natural replacement use for a typical Bank style property is a restaurant or bar, but in a small town the pedestrian flow may not support the use, and the occupying covenant is likely to be weak.

On the other hand, a shop investment immediately next door to a Bank can be occupied by a major retail covenant, will be a building suitable for occupation by many other retailers, and can presently be bought for a yield at least **1%** better than a Bank.

I referred previously to the Vodafone investment we sold at **7.4%.** A year earlier in a weaker market we sold a building two doors away of similar size and arrangement, but at a yield of **6.2 %,** because it was let to a Building Society. Although one of the smaller ones it was nevertheless perceived as a Bank style investment. Vodafone is a business 10 times the size of that Building Society.

The factors for consideration of a commercial property investment should be: 1 - Location; 2 - Accommodation; 3 - Tenancy; 4 - Covenant; 5 - Condition; and in that order of priority.

First	Location	-	The one factor you cannot change
Second	Accommodation	-	Does the building have the flexibility to suit a number of occupiers and is it of a size and arrangement that meets current requirements?
Third	Tenancy	-	Is the lease full repairing so that the Tenant must do all repairs? Is the rent review clause properly drafted? Is the freehold Title good?
Fourth	Covenant	-	Is the Tenant strong enough to pay the rent and keep the building in repair? Does the Tenant have enough assets to survive an economic downturn?
Fifth	Condition	-	Is the property structurally sound? Minor wants of repair and decoration can be ignored - they are the responsibility of the Tenant, but a prudent Investor will have a Building Survey done before exchanging contracts.

In the final part of this Paper, I address **how** can you invest in commercial property, and return to the first problem, which is the lumpiness of this asset class. Do you have to be rich to invest in commercial property? Well, like almost everything else in life, it helps, but not as rich as you might think. The commercial property market runs on borrowed money, and there are many Lenders keen to provide mortgage finance secured on well let buildings.

It has been estimated that some **600,000** people in the UK, that's almost 1 % of the population, have liquid resources available for investment at or in excess of **£100,000,** and that **300,000** people have over **£250,000** readily available for investment. There may even be one or two of them here today!

A well let commercial property investment costing around **£500,000,** can be leveraged with mortgage finance to **75%** of value, that is **£375,000.** This leaves a cash balance required of **£125,000** and with standard purchase/financing costs at about 7% of the price, a further **£35,000** or so, the total cash input a Private Investor would need in this example to own a half million pound property would be around **£160.000.**

The Government now permits everyone to create their own Pension Scheme and choose where to invest their monies. Commercial property is particularly well suited to this form of long term saving and investment structure, with its characteristics of reliable income stream and Lease security. With borrowings permitted up to **75%** of the cost of the property investment, a Private Individual can through his Self Invested Personal Pension or SIPP use a **£100,000** pot to purchase a **£400,000** property. This can be particularly attractive for the self employed, where the freehold of the property in which they operate their business can be purchased by the Pension Scheme and leased back to the business in a highly tax-efficient structure.

Commercial property is a more complex and sophisticated market than its residential cousin. In the house market if No. 89 sells for **£100,000,** then No. 95 will probably not be much different in value.

In the commercial property market, shops can be vastly different in value even when located within **10** yards of each other. An office investment can be worth much more than its adjoining identical twin, because of the covenant of the Tenant and the structure of the Lease. An industrial building may be worth much less than a similar neighbouring property, because of a low eaves height and an inadequate service yard.

So where do we start? Well, the smaller Private Investor could look at the increasing number of commercial property investment funds which several of the major Institutions such as Close Brothers, Norwich Union, Scottish Mutual, Scottish Widows and Standard Life are now promoting to the Private Investor market and where investments can be made from **£7,000** upwards. However, I would advise caution here as many of these products offer moderate value, being secured on lower quality commercial property and strapped with excessive fee structures. Whilst they are likely to preserve the levels of income yield at initial offer, usually between **6.75%** and **7.5%** they are unlikely to offer significant capital growth.

Bear in mind as you see an increasing number of advertisements for these products in the financial press over the coming months that many of the Providers are the same nice people who asked for your money for their ISA-based equity schemes three and four years ago.

Alternatively you can attend the commercial property auctions which are usually held every two months or so in London and where commercial properties are sold in an open and transparent way. After a few months you will begin to appreciate what is, and what is not, good value.

Or you can register with a specialist firm of Investment Surveyors such as my own who advise Private Clients on all aspects of Commercial Property Investment either in outright purchase or by participation in Syndicates.

Commercial Property Investment Syndicates for the Private Investor were pioneered by Ratcliffes in 1990. To date we have purchased over 150 properties in syndicated structures, sold over 110 properties profitably on, and currently manage over 40 properties with a total capital value in excess of £55 million on behalf of some 200 Investors. In the 13 years of these activities to date, I am able to state that our Investors have yet to lose a single penny invested in our syndicates, every one of which has been profitable to date. This is not entirely due to our brilliance, but because prime commercial property is inherently a low risk asset class particularly by comparison with equities. We purchase prime shops let to household name Tenants such as Dixons, Next, Superdrug and Woolworth and offices let to the Government, major plcs or leading professional firms, in lot sizes between £2 million and £6 million, using mortgage finance where appropriate, and creating syndicates with shares therein ranging between £50,000 and £150,000.

We therefore give our Investors diversity and the security of a spread over several property investments. Furthermore, should an Investor wish to sell his share it is invariably taken up rapidly by another Investor in the syndicate - a process which can be arranged within 10 to 15 days.

Our syndicates are designed to overcome the Cold Custard Syndrome of commercial property's perceived draw backs - the lumpiness and lack of liquidity . You could say that Ratcliffes keep the custard hot for our Investors to enjoy a slice of the pie!

In conclusion, you are investing money you have worked hard to make.
Place it where you feel comfortable, either because you understand the asset class or have confidence in your Advisors. That holds true whether you are investing in property, equities, gilts, cash, antiques, fine wines or classic cars. Your investments should give you performance, satisfaction and enjoyment, but not sleepless nights.

Thank you for your attention.