Count the cost of syndicated schemes

Private investors in property vehicles risk losing their profits to promoters, thanks to a punitive fee structure borrowed from the unit trust industry. Anthony Ratcliffe reports

Heed the warning: City slickers, having previously exploited the public's stock market obsession with their share investment schemes, are now promoting commercial property investment schemes, targeting inexperienced private investors who now believe that property is the new panacea.

But the quality, and indeed the nature, of many of these entrants to the syndication market is suspect.

It is astounding that the products on offer have been approved by the Financial Services Authority for marketing to the general public, without the FSA having undertaken a proper analysis of the charges promoters are levying on their new investment vehicles.

Most of the recent entrants to property syndication, which base their fees on those that are well established in the unit trust market, are charging investors an entry fee of around 6%. Therefore from a £100,000 investment, £94,000 is actually applied to the property and the purchase/financing costs thereon. The entry fee is usually split between the promoter and the independent financial adviser who has introduced his hapless client.

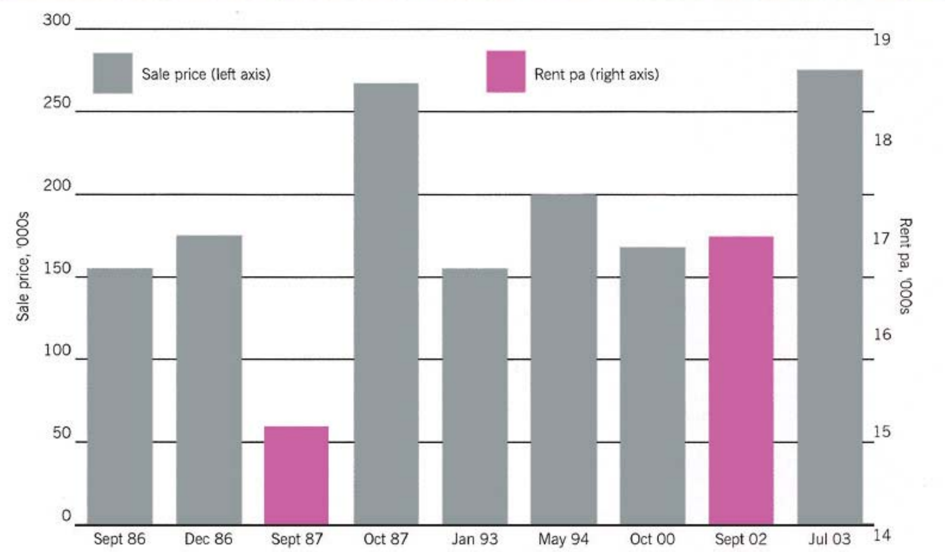
Then there is the annual asset value fee of around 2%, which I consider particularly insidious. This is applied on a leveraged fund, so that where the investor has subscribed, say, £100,000, typically leveraged by 75% to a gross investment circa £400,000, the 2% annual asset value fee levied thereon is effectively 8.5% on the investor's net cash.

Price of performance

Having cut deeply into the investor's potential returns with these standard fees, insult is then added to injury by charging a performance fee at anything between 25% and 50% of the final profit achieved, sometimes after a modest performance target of around 9% pa compounded has been met, and sometimes with no performance target whatsoever.
Furthermore, the promoters levy these charges on top of the professional fees charged by the surveyors who are retained to do the actual work.

Peaks and troughs: the sales history of one property

An investment in Wisbech, Cambs shows why property should be bought and sold according to market cycles



Source: Ratcliffe's. The rent did not increase for 15 years and then only by 13.33%. The peak capital value achieved in October 1987 was not surpassed until 16 years later, although the property was sold profitably four times in that period.

Property presently remains outside the remit of the FSA, but when these dubious schemes have matured, several years from now, with minimal returns to the investors and substantial rewards to the promoters, I expect the FSA to extend its power to encompass property investment, bringing fettering legislation, additional expense and bureaucracy to the industry as a consequence.

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Eight rules of investment

- 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.
- Do not buy a property for the purpose of absorbing 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.
- Do not be seduced by covenant – it should be the least important factor when evaluating an investment. The first consideration must be location, which cannot be improved. The second is the accommodation, which should be suitable for a range of different occupiers in case the existing tenant should fail. The third is the physical condition of the property. The fourth is the lease structure. The last and least important consideration is the covenant strength. Defects in any of the above can be rectified, with the exception of the location.
- Do not borrow more money on a purchase than the rental income will service. If the occupational covenant is weak, do not buy with full leverage unless the rent is well below the market rent and lease forfeiture would be to your advantage.
- Do try to add value while the property is in your ownership, such as by serving a wants of repair schedule or proposing lease restructure to the tenant if appropriate. Ideally, the property should be enhanced in some way before it is resold.
- Do remember that not only does the property investment market have its peaks and troughs, but so do individual property investments (see graph). 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 review, provide good capital growth.
- Do not hold a property investment once it is ex-growth. Trade on when its potential has been exploited for someone else to enjoy the post-rent review growth.
- Break any and all of these rules if the deal feels right!