Time for rich list wannabees to go shopping in the high street

Those enviously reading today's accompanying rich list might turn to p180 for instruction – then apply Anthony Ratcliffe's rules on how to prosper.

Rule one: "When it is impossible to buy anything it is time to sell everything – and when it is impossible to sell anything it is time buy something." The first half of that rule is now being ignored. And the second half will, of course, be ignored when the time comes.

The more serious point made by Ratcliffe – who has run a small but successful collective investment fund for over 30 years – is that retail beats offices every time. Over the past 15 years his fund has bought and sold 97 retail properties, but only six office blocks. The former brought annual returns of 28.2%, the latter 15.8%.

His advice is to buy prime high street pitches occupied by a fading retailer. The rationale is that the struggling sector will soon find high street rents more attractive than the high rents and service charges of the average shopping centre.

Correct? Who knows? But the second half of Ratcliffe's rule may soon start to apply to retail, where pre-Christmas gloom is already gathering. It may soon be hard to sell shops. Therefore it may soon be time to start buying.

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The well-filled shopping cart

Private investors Forget the accepted tenets of property trading – retail specialist Anthony Ratcliffe has secrets that he's willing to share

Recall the old adage, "Buy from the frightened to sell to the greedy". Private investors are rarely greedy but they are often frightened, or at the least, apprehensive. Many of them have suffered the vagaries of the stock market, the horrors of Lloyd, the troubles of previously revered institutions such as Equitable Life. They are not looking for outstanding investment returns. They are looking for safety, for the preservation of their capital, and a fair rate of return upon it.

A private investor said: "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 said: "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."

Many private investors have made their fortunes in other areas and are unfamiliar with commercial investment property. Some think that it is not too different from residential investment 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. Everyone's principal investment should be the house in which they live, with other asset classes considered thereafter.

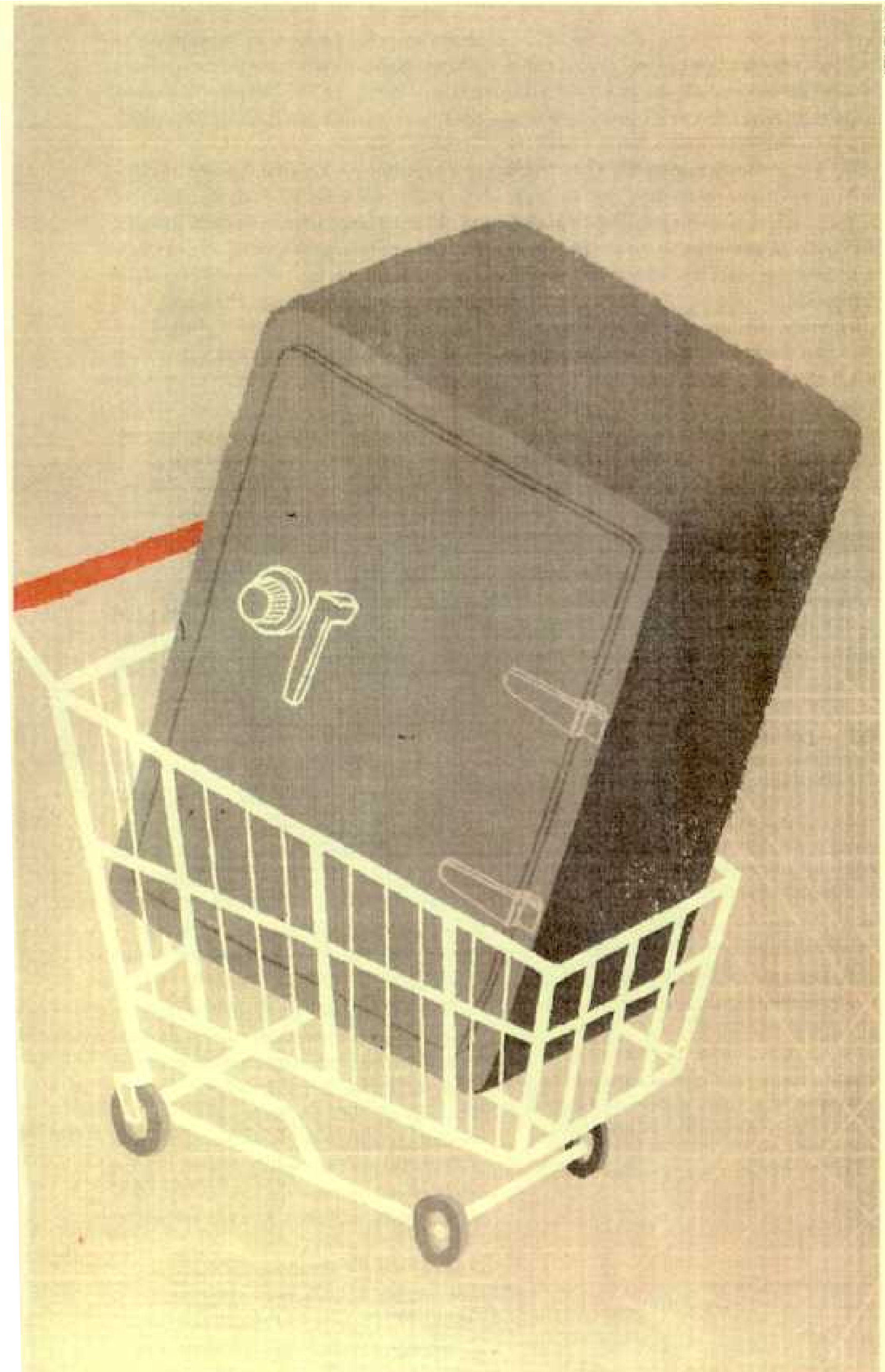
Nevertheless, the risk/reward ratio of commercial property is highly attractive compared with that of other asset classes. Residential rental income is typically poorly covenanted, sporadic and uncertain. Commercial income is usually well covenanted, regular and certain.

Residential dwarfs commercial

Commercial property is a relatively small asset class with a value of around £600bn compared with residential property, which has a value of around £3 trillion and a stock market value currently close to £1.7 trillion. In those years during which commercial property becomes the investment panacea, it is not difficult to have an overheated market, which is what we have today.

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, it was caused by 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 is 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, in which property capital values grow as a consequence of rental growth. While yields 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 or her investment portfolio.

So where should private investors commit their money?

Retail properties instead of offices

My firm buys nine times more high street retail properties than offices. Why? 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% pa. Why do we buy any offices? In fact, we do buy the no-brainers: prime buildings on good covenants let to tenants such as the government on long leases. But we buy 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 past 15 years, for our private client syndicate structures, we have bought and resold 97 retail properties but just six office buildings. The offices returned an average 110% on capital employed, over an average ownership period of 5.4 years, with an average annual compound return of 15.8% – not too shabby.

But our retail investments returned 87% on capital employed, over a shorter average ownership period of only 3.6 years, delivering an average annual compound return of 28.2%, compared with 15.8% average annual compound return on our office investments, a difference of 12.4% pa compounded.

Nevertheless, considering the negative rental growth in the office sector over the past 15 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 six were office buildings.

Yet 15 of the largest institutional property fund managers still hold an average of 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.

Putting the cart before the horse

To my mind, that is putting the cart before the horse. We 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 is location. This is 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 is accommodation. The property must provide well arranged and flexible accommodation capable of housing a wide range of occupiers.

The third is title and 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 is 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.

And lastly is covenant. The property should ideally be let to a strong company that will be regarded as capable of paying the rent, meeting the lease obligations and keeping the building in good repair over 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 forget that a) the building might only be suitable for occupation as a bank, b) banks are gradually exiting the high streets and are unlikely to renew their lease upon expiration, and c) once the building returns to the landlord, considerable expenditure may be necessary to make it suitable for alternative occupation.

> Much of the current retail distress is within shopping centres, where asset managers have massaged rents to the points where retailers are struggling to make a profit

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 – 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 buy only 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 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.

We try to teach our clients not to fall in love with their properties. In the second world war, 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.

Buy before the next review

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 said, they are our prey.

The FTSE Index over the past 15 years has shown an average return of 10.56% pa compound, but by comparison with commercial property investment, this market is a casino. 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.

Ratcliffe's Rules

- 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.
- Do not buy a property to absorb available cash. Buy a property because it is too good an opportunity to lose and then find the money.
- 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. The third is good title and tenure. The fourth is the condition of the building. The last and least important is the covenant strength. Defects in all of these can be rectified, with the exception of the location.
- Do not borrow more money on a purchase than the rental income will service.
- Do try to add value while the property is in your ownership. Ideally the property should be enhanced some way before it is resold.
- 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.
- Do not underpay for an overlet investment. It is better to overpay for an underlet investment.
- Do not hold a property once it is ex-growth. Trade on when its potential has been exploited.
- Break any and all of these rules if the deal feels right!

Anthony Ratcliffe is a director of Ratcliffes.
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