Pension funds find a property solution

With property now providing better returns than many shares, syndicates are offering small pension schemes such as SIPPs a more liquid form of bricks and mortar investment, reports Anthony Ratcliffe.

Thirty years ago, 14% of pension funds' assets were invested directly in the commercial property market; by last year, this figure had fallen to 4%. Over the past 30 years, the stock market has outperformed commercial property investment - but property has outperformed bonds and gilts. Property also involves significantly less risk than equities and is very attractively priced in comparison.

Capital growth performance comparisons can be invidious, as in some years the stock market will handsomely outperform the property market and in others the reverse will be true, but the qualities of property are too important to be ignored by pension-scheme managers.

If capital growth cannot easily be compared, income can, in the analysis of the comparable yields. Taking eight leading shares of the day - Barclays Bank, Bp, Dixons, Marks & Spencer, Next, WH Smith, Tesco and Vodafone - at close of play one night last month, the average yield across those shares was only 2.5%. That 2.5% is after the stock market has fallen for six consecutive quarters and at a time when many equity analysts consider shares to be cheaply priced.

Fixed-rate Strategy

Furthermore, if these shares are held within a pension structure such as a Self-Invested Personal Pension Scheme (SIPP), a 20% tax is now levied on the dividend income, cutting the pension scheme's net yield to just 2%. Yet a property let on a long lease – say, 15 years - to any of these companies can be bought to show a yield of, on average, 8%. So we can achieve a fourfold increase in yield from the 2% offered by our leading shares to 8%, secured on a long-term lease for 15 years or so, and buttressed by upward rent reviews. We can also receive the rental income tax-free within a SIPP structure.

Secured income cannot fall

Furthermore, excepting bankruptcy or a lease expiring, the income is secured and cannot fall. When a company is facing hard times it must pay its rent to stay in business, whereas dividend income could be cut.

A quoted company is selling investors a paper stake in itself - shares can and do melt down in value, sometimes to the point of extinction. Property, on the other hand, is tangible - it can be seen, touched, occupied and used. Its value may fall, sometimes drastically, but it is hard to see how the value could fall to the point of extinction, for the building and the land on which it stands will continue to exist. This is why SIPP schemes should invest in commercial property.

A specific example is even more enlightening. At the market's close on 25 July, Vodafone's shares were 138p, down from their year's high of 341p - a 60% value loss. But even at this historic low, the yield on Vodafone shares is only 1%. My firm is arranging the sale of a newly refurbished building held by Vodafone on a 15-year lease. The asking price reflects a net initial yield of 7.5%. I wonder by how much Vodafone shares would have to rise to justify an annual 6.5% yield differential between the two investments.

Our product is now priced at a level typically offering a 400% higher income return, in terms of rents received from, say, Dixons, Next or Tesco, than the dividend income from those same companies.

Of course property does have drawbacks, which I sometimes describe as "the cold custard syndrome". What does commercial property have in common with cold custard? They are both lumpy and are not liquid.

A SIPP scheme seeking the security of investing in a leading company can buy shares for a few thousand pounds. But if the trustees wished to invest in a prime commercial property let to such a covenant, they would need several hundred thousand pounds - this is the lumpiness of property as an asset class.

For this reason, small pension schemes have traditionally been unable to directly invest in prime commercial property, either because their funds were insufficient to acquire the asset, or if they were sufficient, the scheme's exposure could be to just one property - an approach comparable to placing one's entire stock market investment in just one company.

Months to disinvest

The second drawback with property is its lack of liquidity. If the *Sunday Times* is bearish on the prospects for shares; nervous trustees can liquidate a share portfolio on Monday morning and be back in cash 10 days later. But if the property market starts to slide and trustees wish to disinvest, the process can take several months, perhaps even a year or more.

Of course, it could be argued that a quadrupled yield, of 8% as opposed to 2%, is handsome compensation for these two acknowledged drawbacks of property.

However, syndicate structures of the type now being arranged by my company also allow small pension schemes to overcome some of property's traditional drawbacks as an asset class.

Our syndicates break prime commercial properties valued at between £500,000 and £5m into manageable units for investment by SIPP schemes, which then buy shares in a syndication venture, with prices struck between £50,000 and £100,000 per share.

The properties we buy are held in newly established property nominee companies, which enter into a deed of trust with the syndicate of participating investors, each of whom owns a defined share of the property.

Where appropriate we enhance the property's capital growth performance by arranging mortgage monies to 75% value with a leading building society, and all mortgages are entered into on a non-recourse basis. Mortgage lending rates of around 6.5% are currently available, and with average property yields being around 8%, investors make a positive return on their investment capital but also a 1.5% return on the mortgage borrowings, further strengthening the case for property investment.

Fixed-rate strategy

A further safeguard for investors is built in by fixing the mortgage interest rate for the envisaged period of property ownership; two, three or five years, depending on our strategy for the investment.

We also increasingly arrange syndicates on properties bought for their income without recourse to borrowing. A secure income stream at around 8% distributed quarterly following receipt of rents is an attractive return at this time by comparison with money market or building society deposit rates, and the syndicates we arrange for income will usually operate for several years.

As a consequence, an active market in shares held by the income syndicates has developed. Where an investor wishes to recoup their investment, there is demand for the share from other investors, usually within the syndicate, and a transfer can usually be arranged within two weeks - an attractive solution to the lack of liquidity of the direct property investment market.

Participating investors can be Small Self Administered Pension Schemes (SSAPs) as well as SIPP schemes, private individuals, companies, overseas investors, off-shore funds or charities and they can all be blended together in one syndication.

Since 1990 Ratcliffes has acquired more than 100 buildings within syndicated investment structures, of which more than 40 have been profitably sold. We manage more than 60 such properties on behalf of 170 investors, 40% of whom invest with us through their SAPP or SIPP Schemes.

Syndicates clearly provide a solution to the "cold custard syndrome" of property's lumpiness and lack of liquidity. They enable investors to spread risk across several property investments and gain liquidity by trading the shares - keeping the custard hot for investors to enjoy a slice of the pie.

This article is based on a paper presented by Anthony Ratcliffe, principal of commercial property and chartered surveying firm Ratcliffes, at an lnstitute of Directors seminar in London last month on Property SIPPs

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Where SIPPs should start with property investment

On considering what commercial property to invest in first, a SIPP scheme should adopt a strategy that assists development of the beneficiary's business. Buying the freehold interest of the beneficiary's business premises would be the obvious first step – unless these premises are in a declining area or unsuitable for the business and relocation is planned.

Let us take as an example a commercial property, with the business holding the premises on a lease at a rent of £30,000 pa exclusive, and with a rent review due a year hence, when the rent is likely to rise to £40,000 pa exclusive.

If the business owner has around £125,000 in cash or securities invested in his SIPP scheme and the chance to buy the freehold interest in the property arises at, say, £400,000, plus 6% for the purchasing and financial costs, the business owner will need £424,000 to buy the property. A mortgage is permissible to 75% of the price - £300,000 – and the remaining £124,000 can be supplied in cash by the SIPP fund.

The trustees of the SIPP fund can then arrange a mortgage over, say, 15 years. If this were on a capital and interest repayment basis at an interest rate of, say, 7.5%, the annual payments required would be £33,375.

The SIPP scheme can then create a lease from its trustees to the business for 15 years – matching the mortgage term – at the market rental value of £40,000 pa exclusive. The company's rent is a business expense liable for tax relief, and is received tax-free by the SIPP fund, which can reinvest the annual surplus after meeting mortgage payments.

At the end of the mortgage term the property will be owned debt-free by the SIPP scheme. If the owner of the business then wished to sell it, the SIPP scheme could continue leasing the property to the new owners of the business, giving an attractive income stream to the SIPP scheme's beneficiary in the years or retirement.