Investment
Property Forum

Understanding Commercial Property Investment

A Guide for Financial Advisers
2007 Edition

This guide was commissioned by the Investment Property Forum with funding from the Investment Property Forum Educational Trust, the RICS and the British Property Federation.

The Investment Property Forum (IPF) has over 1,800 individual members drawn from a wide range of different professional communities including fund management, surveying, law, banking and accountancy. The Forum's mission is to improve the awareness, understanding and efficiency of property as an investment, for members and others in the wider business community, including government, by:

- Undertaking research and special projects
- Providing education
- Encouraging discussion and debate

For further information on the IPF, visit: www.ipf.org.uk

The Investment Property Forum Educational Trust is one of the leading promoters and supporters of education and research related to investment property as an asset class. The objectives of the Trust are the advancement of education in connection with the financing, development, management, valuation, ownership and marketing of land, property and buildings, as well as other general charitable purposes. For further information, visit www.ipf.org.uk

The British Property Federation (BPF) is a long established and well respected trade association, which has achieved a considerable degree of success in representing to government the interests of the property owning and investing industry. Its mission is to sustain and promote the interests of all those who own and invest in property in the UK.

The key feature of the BPF's strategy is to persuade the Government that the property industry is a vital component of a successful economy and also an important route by which the Government can achieve the delivery of many of its key policy objectives: particularly urban regeneration, social inclusion, entrepreneurial success, savings and pensions reform and environmental improvement. For further information, visit www.bpf.org.uk

The Royal Institution of Chartered Surveyors (RICS) is one of the most respected and high-profile global 'standards and membership' organisations for professionals involved in land, valuation, real estate, construction and environmental issues. It has:

- 136 years of representing property professionalism
- 110,000 members across 120 countries worldwide
- 300 degree level courses approved worldwide
- 500 research and policy papers published per year
- 50 national associations, linked groups and societies
- 160 diverse 'specialisms' – represented across 16 'faculties'

Accountable to both members and the public, the RICS has four main roles:

- To maintain the highest standards of education and training
- To protect consumers through strict regulation of ethics and standards
- To advise global organisations, governments and regional boards
- To publish market information and research

For further information, visit www.rics.org.uk

This guide is also supported by **Investment Property Databank** (IPD). Set up in the UK in 1985, IPD is now the world leader in real estate performance analysis. IPD produces benchmarks, market indices and detailed research. Reporting and analysis from IPD helps players within the real estate industry, from investors to occupiers, get the most out of their property. IPD now operates in over 20 countries including 15 European Union members, the US, Canada, South Africa, Australia, New Zealand and Japan and continues to expand its global reach. For further information visit www.ipdglobal.com

Do you know the top performing asset class over three and five years?

Are your clients looking to diversify risk in their portfolios?

Which asset class delivers stable and relatively high income yield?

What products give your clients access to these attributes?

Individual investors are increasingly interested in commercial property. The recent ups and downs of the equity market highlighted the benefits that real estate can bring in diversifying a portfolio, and property's stable income flow is attractive to those worried about the adequacy of their pension provisions. In response, a growing number of financial institutions and other product providers are devising commercial property funds targeted at private investors.

If you would like to offer advice to your clients on these products, you need to understand the attributes of commercial property as an investment class and the mechanics of the market. An overview of the commonly available product structures is also crucial, not to mention some insights on the associated risks, the tax implications and regulatory considerations.

This guide is designed to provide this information from a reliable and unbiased source. It is essential reading for all financial advisers including independent financial advisers, private bankers, wealth managers and pensions managers.

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1 Introduction

Until recently, commercial property has been the domain of institutional and professional investors. Today, it is attracting widespread interest from individual investors. The volatility of the equity market has highlighted property's benefit in diversifying a portfolio, while its stable and secure cash flow appeals to those concerned about providing adequately for their retirement. As a result, financial institutions and other product providers are structuring commercial property funds targeted at individual investors. And, from 1 January 2007, real estate investment trusts offer investors a tax-efficient corporate vehicle. These trends present new opportunities for investors and their advisers.

However, indirect investment in commercial property is not straightforward. It is important that financial advisers, private bankers, wealth managers and pensions managers appreciate fully not only the opportunities but also the risks. That way, they will be able to provide the highest quality advice to their clients.

Commissioned by the Investment Property Forum and funded by three leading property industry bodies – the Investment Property Forum Educational Trust, the British Property Federation and the RICS – this guide aims to raise financial advisers' understanding and knowledge of commercial property investment by:

- Describing the commercial property investment market, in terms of size, main property types, and key players
- Setting out the main features of property as an investment in the context of other asset classes
- Examining how the market works in terms of ownership structures, the transaction process, value-adding activities, valuation and performance measurement
- Examining some of the key issues that financial advisers should be aware of when considering whether a commercial property investment product is suitable for a client
- Providing details on the different ways that individual investors can gain access to commercial property
- Examining the risks associated with commercial property investment so that financial advisers are better placed to inform their clients about the kind of risks they may be taking on

Readers should note that this guide was originally published in December 2003, but it has since been revised to reflect the legal, tax and regulatory frameworks prevailing in December 2006. Also, it relates to the UK, but it has been written primarily from the legal perspective prevailing in England and Wales. Different legal regimes operate in Northern Ireland and Scotland.

Reita – The REITs and Quoted Property Group

For financial advisers who wish to find out more about the quoted commercial property investment market, we recommend that they visit the website www.reita.org Reita has been created by The REITs and Quoted Property Group to provide an impartial source of expert information on quoted property investment and REITs. The group is funded and supported by leading companies in the property and financial services sectors including the British Property Federation and the Investment Property Forum.

2 The commercial property market

How big is it?

There is about £762bn of commercial property in the UK. In comparison, the private residential market is valued at £3,400bn, while the equities market – as measured by UK companies quoted on the London Stock Exchange – is worth £1,781bn*.

The core sectors of commercial property – shops, offices and industrial – account for about 80% of the market, £609bn. Around half of this is investment property, that is, rented to tenants by landlords. The remainder is mostly owned by occupiers, mainly private companies and, to a lesser extent, public sector and non-profit organisations.

The proportion of investment property is gradually rising as owner-occupiers release the capital tied up in their buildings by selling them to investors and taking a leaseback. For example, food retailers Tesco and Sainsbury's have both done this with some of their supermarkets and distribution centres. The Government, too, has arranged sale and leasebacks for large packages of its property, including the Ministry of Defence's housing stock.

Who are the investors?

As the pie diagram shows, a wide range of organisations and individuals invest in UK commercial property.

Financial institutions

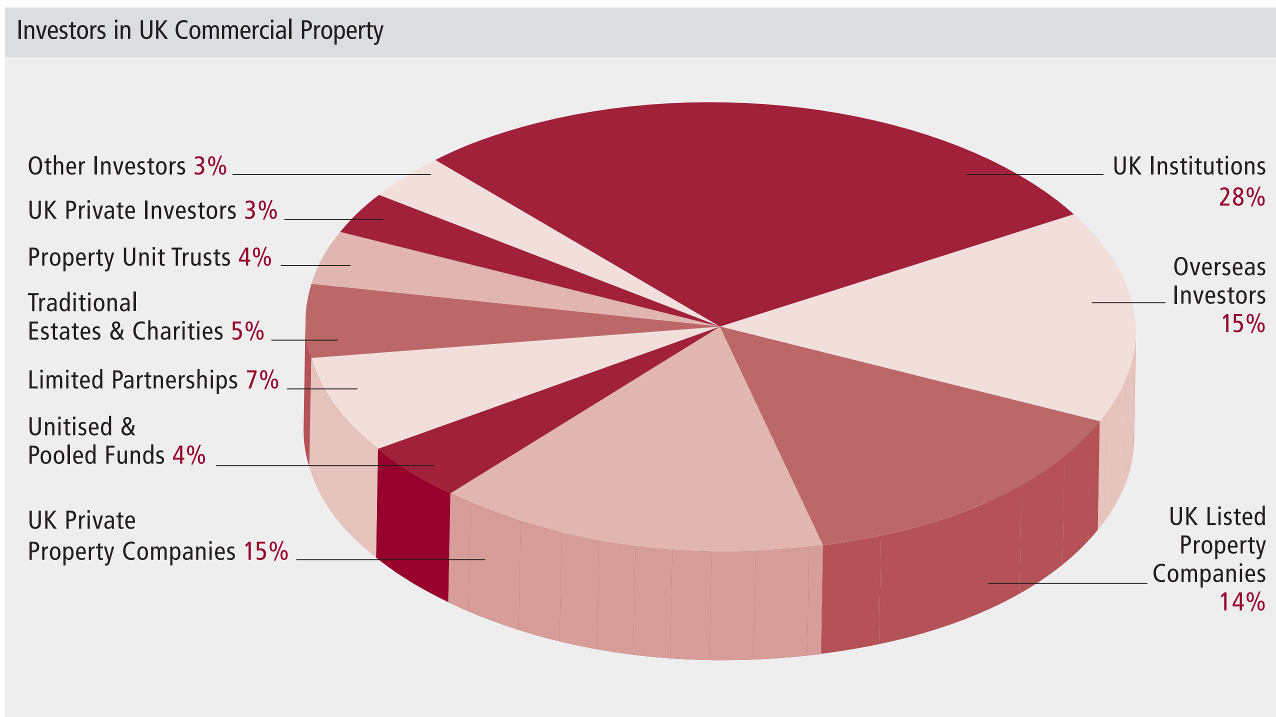
UK insurance companies and pension funds together hold the largest block of investment property, 28%, as portfolios of directly-owned real estate. These institutional investors also have large indirect holdings via their stakes in unitised and pooled funds, property unit trusts and limited partnerships. In total, they own an estimated 40%, by value, of the core commercial investment stock.

UK property companies

There are 114 quoted property companies in the UK. Currently they hold around 14% of the UK's investment stock. However, this sector is likely to dwindle with the introduction of REITs, a new tax-efficient quoted corporate vehicle, in 2007 (see p19).

There are also over 3,300 private property companies. These range from the very large to small ones that own a single property.

Investors in UK Commercial Property



*Estimate for end-2005, based on research undertaken for the IPF by Cass Business School, DTZ and Investment Property Databank.

Overseas investors

Foreign investors are now a significant force in the UK. They own about 15% of the commercial property investment stock, and according to DTZ's **Money into Property**, they spent £12bn buying UK commercial real estate in 2005. Typically, these overseas buyers are looking to enhance their returns and/or diversify their risk by investing outside their domestic property markets.

However, other factors besides returns and diversification can influence their choice of the UK. For example, in recent years, Irish syndicates have been particularly active investors here. According to DTZ's monitoring, in 2005 alone, Irish investors purchased £2.8bn, or 22% of all foreign spending on UK commercial real estate that year.

Clearly, they are attracted to UK property by its performance prospects and because the yields offer a margin over their finance costs. But the UK's familiar lease structure, geographical proximity and common language are also factors that appeal to Irish investors.

Traditional estates and charities

Traditional estates such as Grosvenor, Portland, Cadogan, the Crown and Church Commissioners, together with charities and charitable trusts, account for 5% of the market.

Private investors

In recent years, private investors' interest in commercial property has sharpened because of the volatile equity market and worries over the adequacy of their pension provisions. However, because direct investment in commercial buildings requires relatively large amounts of capital, most private investors have opted for buy-to-let residential property.

But increasingly, financial institutions and other product providers are launching commercial property vehicles for smaller investors. So far, most have targeted high net worth individuals and 'sophisticated investors'.

Limited partnerships and unit trusts

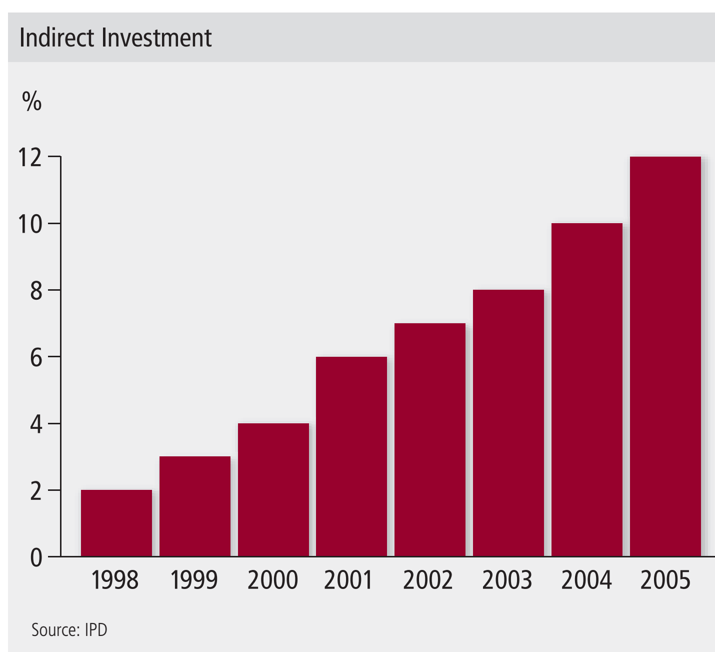
Limited partnerships have been the indirect vehicle of choice for many investors. Not only are they tax transparent, but they also provide specialist management and/or access to a pool of assets in a particular market sector. Moreover, limited partnerships often use debt finance. This makes them particularly attractive to institutional investors, who may only make limited use of gearing when investing directly.

However, the Finance Act 2004 introduced Stamp Duty Land Tax provisions that affected both the value and liquidity of limited partnership interests, particularly those using debt.

Consequently, institutional investors are now keener on offshore property unit trusts. Usually based in the Channel Islands, these PUTs offer tax efficiencies as well as some liquidity in units (see p18).

As the chart below shows, institutions, listed property companies and traditional estates/charities are making more use of these vehicles, and the proportion of real estate that they hold indirectly has grown significantly over the last seven years.

Indirect Investment



Source: IPD

Other key players

Developers

Developers play a key role in assembling sites, organising the services of specialists, and finding the finance to produce a building or bigger complex. Where development is undertaken speculatively, that is, without a contractual commitment from a tenant, the financial risk can be significant, but then so can the rewards.

Many investors also develop on their own account or through joint ventures to create the stock for their portfolios and to enhance their returns. Institutional investors will often share an element of risk with a developer by committing to acquire a building either before construction commences or part way through the process. By contracting to buy the scheme, sometimes before a tenant has been found, the investor makes it easier for the developer to secure finance for the project.

Bankers

As well as providing development finance, bankers also lend to a wide range of investors who want to leverage their equity with debt. According to De Montfort University's latest research, there was over £156bn of loans outstanding on commercial real estate at the end of 2005. Investment property accounted for 75% of this and developments for 13%. The largest borrowers, accounting for two-thirds of the total, were private property companies.

Occupiers

The commercial property market places considerable emphasis on the financial strength – the covenant – of an occupier. This, along with the lease terms, is critical in assessing both the risk in, and the value of, an investment.

Thus, developers want to let their schemes to good occupiers, that is, tenants with good covenants, to maximise the value of the building. Investors assess potential occupiers' covenants by examining their financial accounts or using credit rating agencies, such as Dun & Bradstreet.

Chartered surveyors and property consultants

There are about 20,000 firms of chartered surveyors and property consultants in the UK. They provide a range of services, including:

- Marketing properties available to lease, identifying suitable occupiers and negotiating leases for clients
- Negotiating the purchase of properties
- Surveying properties and reporting on their condition and structural soundness
- Managing property for investors
- Valuing property
- Marketing property for vendors

The Royal Institution of Chartered Surveyors is the professional body that ensures the competence and maintains standards of its members.

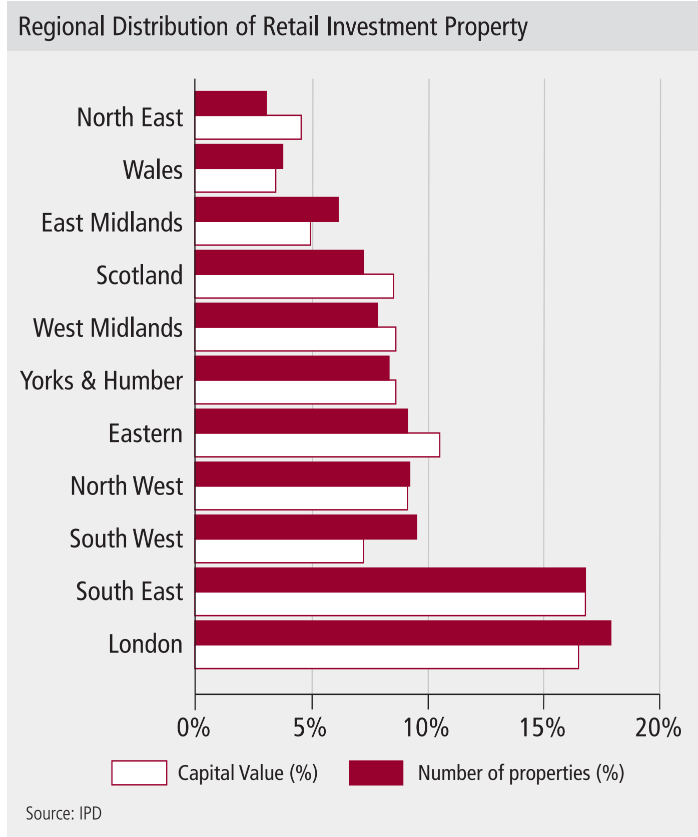
Property types

The three principal sectors of the commercial investment market are retail (shopping centres, retail warehouses, standard shops, supermarkets and department stores); offices (standard offices and business parks); and industrial (standard industrial estates and distribution warehousing, or logistics facilities). In addition, there are several smaller sectors such as leisure (leisure parks, restaurants, pubs and hotels), student accommodation and healthcare properties.

A complete and reliable breakdown of the UK investment market by both sector and region is available only for the £192bn of mainstream institutional property that is monitored by Investment Property Databank. It covers only the three main sectors as the charts overleaf show.

- London and the South East have the lion's share of commercial property investments
- Retail property is more evenly distributed across regions than offices or industrial. Shopping centres, retail warehouses, department stores, supermarkets and standard shops are found in most towns of any size throughout the country and, with the exception of standard shops, come in large lot sizes

Regional Distribution of Retail Investment Property



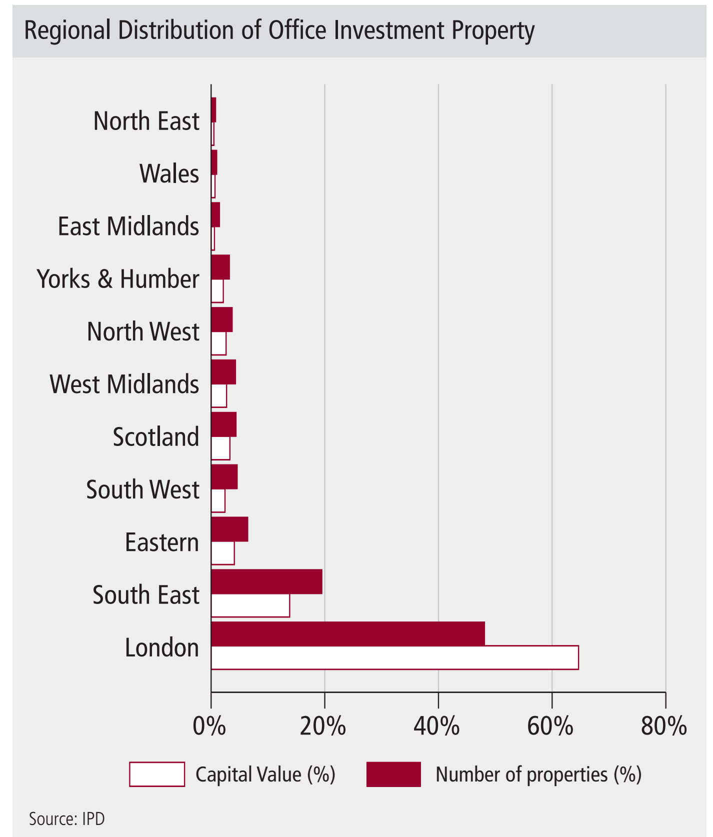
Source: IPD

Regional Distribution of Industrial Investment Property

Source: IPD

- The office market is heavily skewed towards London and the South East. London alone accounts for more than 66% with concentrations in the City and West End
- Industrial property is also concentrated in London and the South East

Regional Distribution of Office Investment Property



Source: IPD

3 Commercial property as an asset class

Commercial vs residential

Commercial property has considerable attractions as an investment. However, it is important to recognise that the commercial property market is very different from the residential one. Residential property investment has boomed over the last decade as rising house prices, small lot sizes and the availability of mortgages encouraged many private investors to enter the buy-to-let market.

But it must be stressed that there are critical differences between these two markets:

- Residential tenants typically commit to relatively short renewable leases, while commercial ones usually sign long-term contracts: periods of 10 years or more are not uncommon
- Commercial tenants are normally liable for repairing the property while landlords of residential property are usually responsible for repairs
- The returns on residential property come mainly from increases in capital value, whereas a large part of the commercial property return is income
- Commercial properties usually cost significantly more, hundreds of millions of pounds, in the case of shopping centres or large office buildings

What commercial property offers

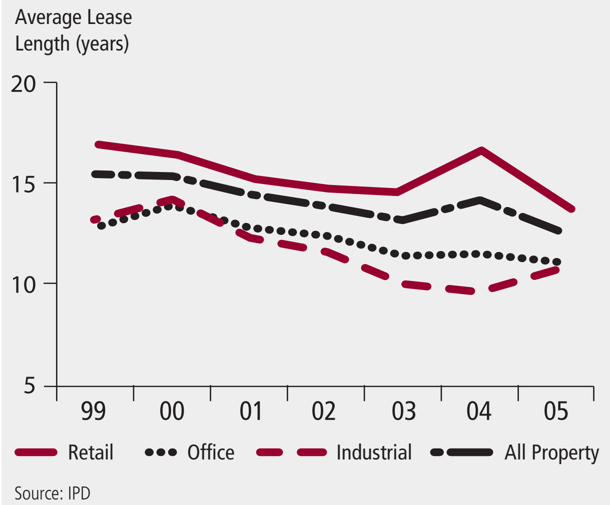
Secure and stable cash flow

On average, commercial property leases provide a contracted income stream of 7.1 years, based on the period to the expiry of the lease, but ignoring break options.

As the chart shows, the length of new leases has been shortening over the last 10 years. Nevertheless, those granted in 2005/6 were, on average, over 10 years for retail property, more than seven years for offices and slightly less than seven years for industrials.

As noted earlier, a significant part of the return from commercial property comes as income. Thus, its income yield is relatively high: 4.9% against 3.2% for equities and 5.6% for gilts in 2006. In a low-inflation environment, this is one of commercial property's attractions.

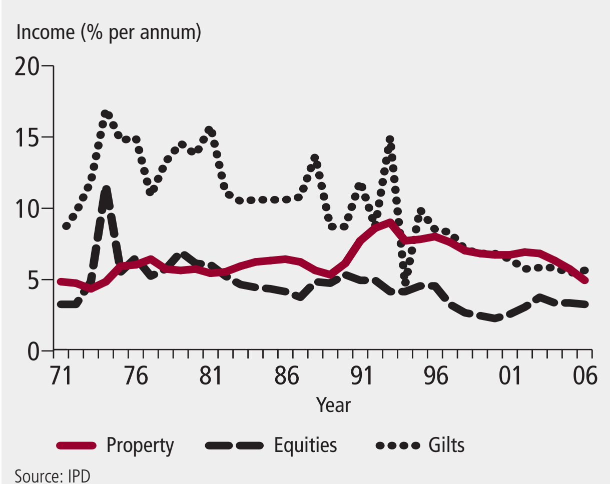
Average Lease Lengths by Sector



Source: IPD

Over the last decade, the income return on all asset classes has been on a downward trend. Even so, the income yield from commercial property has remained relatively stable over time: 6.5% annually, on average, over this period. Meanwhile, capital growth has fluctuated considerably, as the chart on page 8 illustrates.

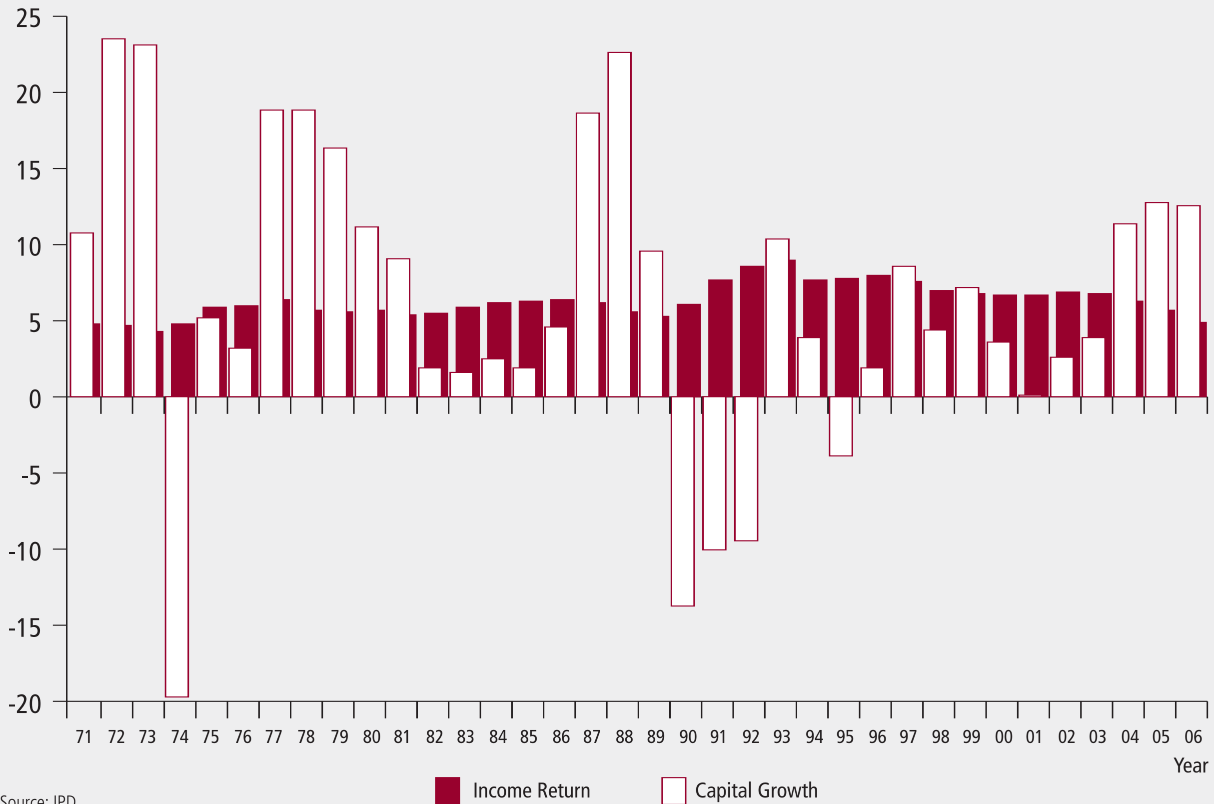
Main Asset Classes: Income Return (nominal)



Source: IPD

It is important to understand that property indices are based on valuations and not transaction prices (see p12). Therefore, they tend to underestimate the true volatility of the market. Nevertheless, even after adjusting to allow for valuation 'smoothing' and 'lag', property's volatility is still lower than that of other assets. (A full discussion of these issues can be found in the Investment Property Forum's report, **Index Smoothing and Volatility of UK Commercial Real Estate**.)

Commercial Property Capital Growth & Income Return



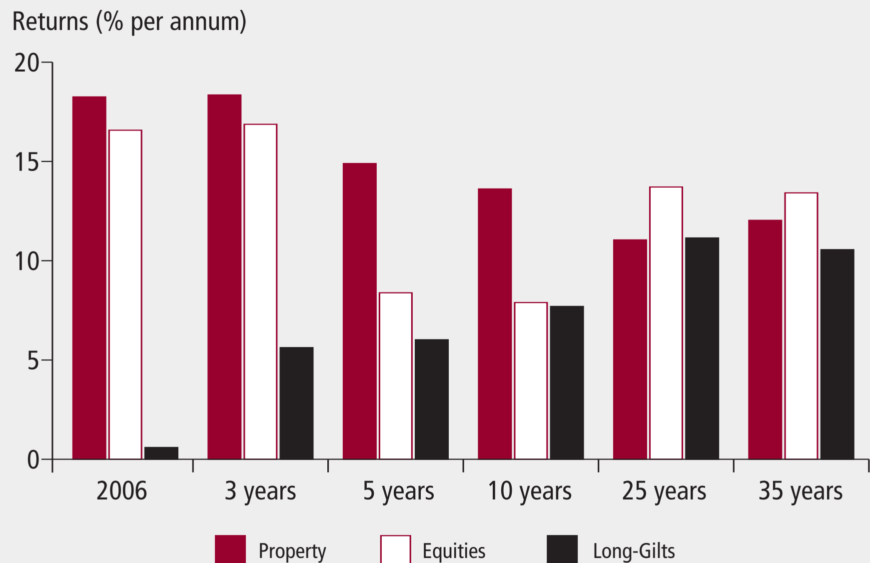
Source: IPD

Performance

Commercial property has outperformed equities, gilts and cash deposits over the last five and ten years, and come a close second after equities over the last one-year and three-year periods.

Even over 36 years, the longest period for which credible data is available, commercial property has produced annualised returns of 12.2%, ahead of both gilts and cash deposits.

Recent Performance Record: Main Asset Classes



Source: IPD

Low volatility

Commercial property has produced a much higher return per unit of risk than other principal asset classes. This includes equities, the strongest performing asset class over the period 1970 to 2005.

Annualised Investment Returns 1970-2006

	1970 Value £	2006 Value £	1970-2006 Return %	1970-2006 Std Dev %	1970-2006 return/ risk ratio
Nominal					
UK Equities	100	9,896.2	13.6	30.6	0.44
Gilts	100	3,841.0	10.7	15.2	0.70
Cash	100	2,073.2	8.8	3.8	2.32
Direct Property	100	6,274.6	12.2	9.5	1.28
Real					
UK Equities	1,057	9,896.2	6.4	25.2	0.25
Gilts	1,057	3,841.0	3.6	14.4	0.25
Cash	1,057	2,073.2	1.9	4.2	0.45
Direct Property	1,057	6,274.6	5.1	10.3	0.49

Source: IPD

Diversification

For those who invest in a range of different assets, property offers diversification benefits. The real estate market in the UK does not follow the same pattern as the two other main asset classes, equities and gilts. In contrast, the performance of equities and gilts is strongly correlated, as the table below shows.

Annualised Correlations 1970-2006

Asset Correlations	Direct Property	UK Equities	Gilts	Cash
Direct Property	1.00	0.19	0.04	-0.27
UK Equities		1.00	0.65	0.08
Gilts		0.65	1.00	0.17
Cash		0.08	0.17	1.00

Source: IPD

Tangible asset

In contrast to bonds or equities, commercial property has a 'psychic value' for an investor because it can be seen, touched, photographed, walked around or driven past. But as a tangible asset, commercial property also needs to be managed, and there are associated costs. These are discussed on p16.

Adding value

Direct ownership of commercial property gives investors opportunities to manage their assets actively, either to sustain the value or enhance it. Unlike bonds and equities, commercial property can depreciate as the structure of the building ages or occupiers' preferences change. By refurbishing or finding an alternative use for the building, the landlord can help maintain or boost its value.

Active management can include:

- Re-negotiating the lease terms of an existing tenant(s) to increase the value, for example by increasing the lease length or increasing the rent payable
- Buying an existing tenant(s) out of their lease commitment, refurbishing the premises and letting to a new tenant at a higher rent
- Redeveloping or refurbishing the property for a different use

4 How the commercial property market works

Ownership and lease structures

The form of ownership and legal rights over a property can make a significant difference to its value. The main issues are outlined below.

Freeholds

The owner of freehold title effectively owns all the property – land and structures – in perpetuity. Freehold ownership may be restricted by covenants and/or by the rights of others, such as rights of light.

Commonholds

This is a new form of property ownership. Essentially the common parts of a development are owned by a Commonhold Association and the owners acquire a freehold unit subject to the terms of the commonhold. However, interest in commonholds has been slow to develop in the context of commercial property investments.

Leaseholds

In contrast, a leaseholder's ownership is contractually limited in time to the length of the lease, though commercial property tenants may have a statutory right to renew it. The lease may also contain restrictions, either expressly in the lease documentation or implied by law.

Break options

Some leases include break clauses giving the landlord and/or the tenant the option to end the lease before its expiry date. These clauses usually specify how much notice has to be given and may include financial provisions.

Break clauses can significantly impact on the investment value of a property because, potentially, the income from the property can change or even disappear at this point. The market norm is to assume that a tenant's break option will be exercised. On the other hand, landlords' break options can have a positive impact, by giving them the opportunity to improve their property's value by, for example, re-letting it to a better tenant or refurbishing it.

Privity of contract

Leases signed before 1 January 1996 are subject to "privity of contract". This means that the original tenant remains legally responsible for the rent and other commitments for the duration of the lease, even after he or she has transferred (assigned) the leasehold interest to another tenant.

For leases signed after the Landlord & Tenant (Covenants) Act 1995 came into effect on 1 January 1996, the position is different. A tenant who assigns his or her lease is generally released from any future liability under it. However, landlords are permitted (and it is market practice) to require the outgoing tenant to guarantee the liabilities of the specific person to whom he or she assigns the lease.

Privity of contract is important because the investment value of a property depends in part on the financial strength of its tenant. For example, a building may currently be leased to a blue-chip company, but if it decides to move and assigns its interest in the remainder of its lease to a tenant of much weaker financial standing, the value of the property is likely to be downgraded, regardless of how many years are left on the lease. This is because the risk of tenant default is now perceived to be greater.

Rent reviews

The rent review period is agreed between the landlord and the tenant and set out in the terms of the lease. Typically, commercial rents in the UK are reviewed every five years.

In general, a rent review is decided by negotiation between the tenant and landlord, and by referring to the rents achieved in the open market for comparable properties. Once agreed, the tenant is committed to pay the landlord a rental income which is effectively fixed (subject only to further reviews) until the lease is terminated.

UK commercial leases have traditionally provided for "upwards-only" reviews. This means that the new rent negotiated on review cannot be lower than what the tenant is currently paying, even if the market rents in the

area have fallen below that level. In this case, the tenant and landlord usually agree to continue with same rent the tenant currently pays.

Although upwards-only reviews are traditional, it should be noted that UK leases can, and some do, specify a different basis for reviewing rents. Leases which spell out an annual amount or percentage by which the rent will increase or link the increase to the retail prices index are becoming more common. In addition, but less frequently, a rent review may state the exact properties to be used as comparables.

If the landlord and tenant cannot agree a rent review, they can ask an independent expert or arbitrator (often appointed by RICS) to decide the matter.

Lease reform

Legislation can affect the returns from any asset class and property is no exception. The Government has said it is concerned that commercial property leases are not providing enough choice and flexibility for tenants.

In response, the property industry introduced a voluntary Code of Practice giving guidance on good leasing practice in April 2002. Following two years' monitoring of this code and a consultation exercise, the Government decided that it would not legislate on lease terms, and in particular, that it would not prohibit upwards-only rent review clauses.

However, the Government is still concerned about the prevalence of these clauses in longer leases, and also about assignment and subletting provisions that can affect how easily tenants can dispose of properties they no longer need. It asked the property industry to review the Code of Practice and is conducting a further three years' monitoring. The Government is also keeping open its option to legislate in future if necessary.

Buying and selling

Market makers

Auctions aside, there is no public market in commercial property investments. It is primarily a private market, made principally by agents who seek to match buyers and sellers with buildings.

Sellers typically engage an agent to market their property. The buyer will usually recognise the agent's role in introducing the property to them, either by retaining the agent to act on the purchase or simply by paying an introductory fee.

With the advent of e-commerce, many agents now market properties for clients via websites and there are several platforms that seek to create electronic market places.

Property auction houses also sell commercial lots for sellers. Over the last seven years the auction market has grown steadily, driven by the growing demand from private investors. Two factors fuelling this demand are that initial yields on properties in the auction room have been higher than finance rates, and there has been a ready supply of debt finance.

Liquidity

Investors often cite a lack of liquidity as a key disadvantage of commercial property. However, research published by the IPF in 2004 found that the UK market average holding period for an investment is seven years. It also found that the holding period has been shortening over time, suggesting steady gains in liquidity. Nevertheless, turnover is relatively low compared to that in the equities and gilts markets.

Two reasons for property's 'stickiness' are that it takes longer and is more expensive to execute a deal (see below). Although the property industry has taken steps to streamline transactions, it can take several months from initial marketing to completion of contracts. This time lapse clearly represents an opportunity cost for investors.

Costs

The costs of buying a property are significant when compared with acquiring interests in other assets. In large part, they stem from the fees associated with the due diligence necessary. The market norm is 1.7625%, which reflects fees, plus VAT for the following services:

- Agents' advice on the purchase, which may sometimes, but not always, include fees for valuation, building surveys, environmental audits and mechanical and engineering tests
- Legal transaction fees

In addition to these costs, buyers must pay Stamp Duty Land Tax on commercial property transactions. The current SDLT rates are: 4% where the price is over £500,000, 3% for prices from £250,000 to £500,000, and 1% where the price is between £120,000 and £250,000.

Valuation

Unlike other financial assets, most commercial real estate does not trade in an exchange with openly quoted prices. Therefore, valuers are used to estimate the likely selling price of an asset. This process combines financial information about the property with market data to come to a balanced, evidence-supported assessment of its price: a valuation. But sometimes not all the pieces of the puzzle are available. Here, the valuer uses his or her expert knowledge and experience of the market to make a judgment.

The RICS Appraisal and Valuation Standards (known colloquially as the Red Book) is the national valuation practice standard in the UK. It is used by RICS members, who value most of the investment property in the UK, and their clients. But even when 'Red Book' standards are used, the valuation of a property and the price it sells for can be different. In part, this reflects the imperfect nature of market information – for example, the seller may know more than the buyer, or vice versa. It can also reflect different views about the future prospects for the property itself and/or how the market generally will perform.

Indices and performance measurement

Commercial property investors need a standard yardstick to measure the returns they achieve on their real estate and compare its performance. This is provided by an independent research company, IPD (Investment Property Databank), which produces objective, reliable property benchmarks and indices for 18 countries, with 3 more in the development or consultation process.

By analogy with paper assets, IPD acts both as a benchmarking service for individual portfolios, like the WM and CAPS services, and as a wider indicator of market movements, like the FTSE Actuaries Index. However, performance is not measured on the basis of transaction data, but by records from portfolio valuations.

IPD's annual database is the most comprehensive benchmark of direct property performance in the UK. It monitors 12,137 properties in 278 funds with a total value of £192bn, equivalent to 49% of the UK investment market. These properties are valued annually, but two subsets are valued more frequently.

The quarterly index, launched in 2006, values 8,003 properties, £122bn worth in December 2006, held in 187 separate funds. And 67 monthly-valued portfolios, 4,249 properties, are the database for the IPD Monthly Index. This latter provides a fast-moving indicator of current market conditions.

The monthly index covers 15% of the UK investment market, but differs in composition from the annual index. For example, it contains few large portfolios and fewer higher value assets, such as shopping centres and central London offices. A summary of the end-month results is published in the Companies & Markets section of the Financial Times.

In 2006, another index series, the FTSE Commercial Property Index, was launched. It differs from the IPD indices in several important respects. Most significantly, it is based on indirect property holdings of a Guernsey-listed real estate fund. This fund is invested in a range of property vehicles and structured so its holdings mimic the UK commercial property investment market. The headline FTSE UK All Property Index has three additional sector

indices, giving investors daily performance data on the retail, office and industrial sectors of the UK commercial property market. It is available by subscription.

There are also the IPD UK Pooled Property Fund Indices, compiled by IPD and sponsored by the Association of Real Estate Funds and HSBC. These measure the quarterly performance of £37bn of commercial and residential property held by some 60 collective investment schemes offering indirect exposure to UK property.

The performance of UK quoted real estate company shares is tracked as part of the FTSE Actuaries All-Share index for UK equities, published daily in the Companies & Markets section of the Financial Times.

5 Investing in commercial property: some initial considerations

Investing directly in commercial property is not as easy as in other asset classes. Lot sizes are large, the market is relatively illiquid, and at present there not many products available for private investors.

Because of this, most small private investors have concentrated on buy-to-let residential property and smaller commercial premises bought at auction. However, there is a growing number of commercial property funds and vehicles available to private investors. Moreover, the introduction of listed real estate investment trusts in 2007 opens up a new sector of tax-efficient quoted property companies (see p19).

In this chapter we review some of the general issues that financial advisers should take into account when considering indirect investments in commercial property. These include the regulatory framework, risk, tax plus fees and costs.

Regulatory context

The UK regime regulating commercial property investment operates within a statutory framework, based on the Financial Services and Markets Act 2000 (FSMA).

Commercial property itself is not a 'specified investment' under FSMA, hence direct ownership does not fall under its remit. However, if the property is held in a collective investment scheme, then those holdings do come under the FSMA regime.

FSMA defines a collective investment scheme (CIS) as one where:

- The purpose or effect of the scheme is to enable persons taking part in the arrangement to participate in profit or income
- Pooled contributions and profits, or property, are managed as a whole by, or on behalf of, the operator
- The participants have no day-to-day control over the property

Thus, property investment vehicles such as limited partnerships and property unit trusts are generally CISs. However, companies are regulated separately.

Under FSMA, CISs are either 'authorised' or 'unauthorised'. Authorised investments schemes may be marketed to the general public. Unauthorised CISs (also known as 'unregulated') cannot be marketed to the public, only particular types of investors. These include:

- Market counterparties: for example, a government, central bank and an FSA-authorised firm
- Intermediate customers: for example, a local or public authority, high net worth company, high net worth partnership or trust and an unregulated CIS
- Persons who currently participate (or have participated in the past 30 months) in a substantially similar scheme
- Established or newly accepted customers of an authorised firm for whom the firm has taken reasonable steps to ensure that the investment is suitable
- Investment professionals, certified sophisticated investors and certified high net-worth individuals

FSMA requires firms that promote an unregulated CIS to take reasonable steps to communicate with a customer in a way that is 'clear, fair and not misleading'.

What is available for private investors?

For anyone looking to invest only a few thousand pounds in a tax-efficient way, the choice is widening all the time. New products are being launched, although the range of funds is not as great as offered by other investment classes. There are currently more than 20 unit-linked life and pension funds, plus authorised unit trusts open to individuals with modest sums to invest. In addition, there are also about 20 offshore unit trusts and offshore property investment companies with UK listings.

However, from 1 January 2007, small investors are able to buy shares in listed real estate investment trusts (REITs). These companies have a special tax status and do not pay corporation tax on income or capital gains from their property investments, making them tax-efficient vehicles (see p19). Most of the UK's larger quoted property companies have said they will convert to REITs. One of benefits of REITs is that, because of their high distributions and tax-efficiency, their returns tend to correlate more closely to direct investment in property than those of ordinary property companies. However, it should be noted that UK-REIT shares are publicly listed and therefore will be subject to the influences of the equity markets and general equity market sentiment.

Small investors can also buy shares in UK-domiciled and listed property companies, but these are not tax-efficient. Their performance also tends to be more closely aligned with the equities market than the direct property market.

REITs, shares in property companies that are listed on a recognised exchange and authorised property unit trusts all qualify for ISA, PEP, CTF and SIPPs investment.

Wealthier and more sophisticated investors have more choice. There is a growing number of products which allow them to invest in property funds via a variety of structures. These products typically require a minimum commitment of £35,000, but £90,000 to £100,000 is usual. Often investors' equity will be geared through use of debt with the underlying property assets acting as security for a bank loan.

Wealthy individuals can also buy commercial property directly. However, because of the large sums required, this will only be viable for a few and even they will find it very difficult to achieve any diversification.

It is possible to buy commercial property directly within a SIPP. However, diversification will still be difficult to achieve and specialist property management skills will be required. Some SIPP providers offer specialist property services.

Some initial considerations

Few investors will have sufficient funds to invest directly in a commercial property. Most will be considering indirect exposure, and there are a growing number of vehicles offering this. However, before considering the different structures available, there are some general points that should be taken into account.

Risk

It is not easy to classify the various products according to their inherent level of risk. We can, however, make some general observations about risk and these are expanded in a later section on the subject (p26).

First, an investment in a single building is likely to be more risky in general than investment in a portfolio of properties, and an investment in a geared product generally carries more risk still.

But the most important consideration is the impact of the investment on the client's total portfolio. A high-net-worth individual with £200,000 invested across four different geared property partnerships/unit trusts, representing 10% of his portfolio, may well have lower overall risk than an investor with 50% of his portfolio in one property partnership/unit trust. Risk, as ever, is a function of individual circumstances as well as the characteristics of the asset in question.

Diversification

As noted above, investing in a portfolio of properties is, generally speaking, likely to be less risky than concentrating all one's capital in a single building. Moreover, investors can also diversify their portfolios by spreading their investment over a range of properties in different sectors and locations.

Sectors can and do perform differently, in the same way that different business sectors of the equity market do not all march in step. The returns from property investments in different locations will also vary depending on the health of the local real estate market. By diversifying their holdings sectorally and geographically,

investors can mitigate the impact of a downturn in returns in one particular sector or location. A fuller discussion of these issues can be found in the Investment Property Forum's report, Diversification in Property Portfolios.

Fees and costs

Like other collective investments, property funds charge fees. However, because commercial property is different from other assets, a wider range of fees and charges are involved. One potential difficulty in understanding the level of fees in property investment funds is that there are several types of fees and costs that may or may not be covered by the initial fees or by the annual management fee. These fall into seven broad groups:

Initial fees

For closed-ended funds, the initial fee typically covers most of the set-up costs. These usually include professional fees associated with establishing the fund (legal, taxation, regulatory), together with the costs of marketing and distribution, including commissions payable to financial advisers.

For open-ended products, an initial charge will typically cover distribution, promotion and marketing expenses.

Property acquisition costs

The initial fee quoted in product literature does not always include the costs of acquiring the properties. Normally, these will be 5.75% of the price paid, of which up to 4% is Stamp Duty Land Tax. The remaining 1.75% reflects the fees paid to agents, solicitors and for specialist surveys.

For open-ended products, the price charged for an investment normally takes account of the costs associated with acquiring underlying assets and may also reflect an initial charge.

Annual management fee

As with other types of funds, the annual management charge refers to the yearly expenses charged for the ongoing management of the fund. However, for property, this charge is usually levied as a percentage of the gross assets of a fund, even if the fund is geared.

To compare fee levels for different commercial property investment schemes it is necessary to check whether there is also a separate charge for property management (see below), or whether this is included in the annual management charge.

Some funds, such as offshore property investment companies, will also charge fees for administration and directors, and in the case of offshore property unit trusts, trustees are also paid fees. These may or may not be included in the annual management fee.

Property management expenses

Managing property is much more labour-intensive than managing paper securities like equities or bonds. It means collecting rents, carrying out rent reviews, letting and re-letting properties, renewing leases, arranging insurance and so on. These activities are known as property (or asset) management and the associated expenses are borne by the fund.

In addition, property funds usually require periodic valuations. These are also charged to the fund.

Sale costs and exit fees

The costs of selling the fund's assets are typically borne by the investor. These costs can be considerable and the industry norm is 1.5% of the sale price. Some vehicles may also include an exit fee, payable on the successful sale of the underlying property assets. These fees are paid regardless of the overall performance of the fund.

For open-ended funds, the price at which units may be redeemed will typically reflect the costs and expenses of disposing of the fund's assets.

Transaction fees

Within diversified funds, including open-ended ones, there is usually some buying and selling of assets as fund managers tactically reposition the property portfolio to take advantage of expected market trends. This activity is not undertaken lightly, since the associated 'round trip' costs of 6.75% to 7.75% can seriously dent short-term performance.

Some funds operate as traders and consequently the costs of buying and selling assets will be borne by the fund. The offshore domiciled, UK-listed property investment companies fall into this category.

Performance fees

In addition to the fees and costs outlined above, there may be a performance-related fee that is payable to the manager or sponsor where some pre-determined hurdle is reached. Some performance fees are paid during the life of the fund, others on termination.

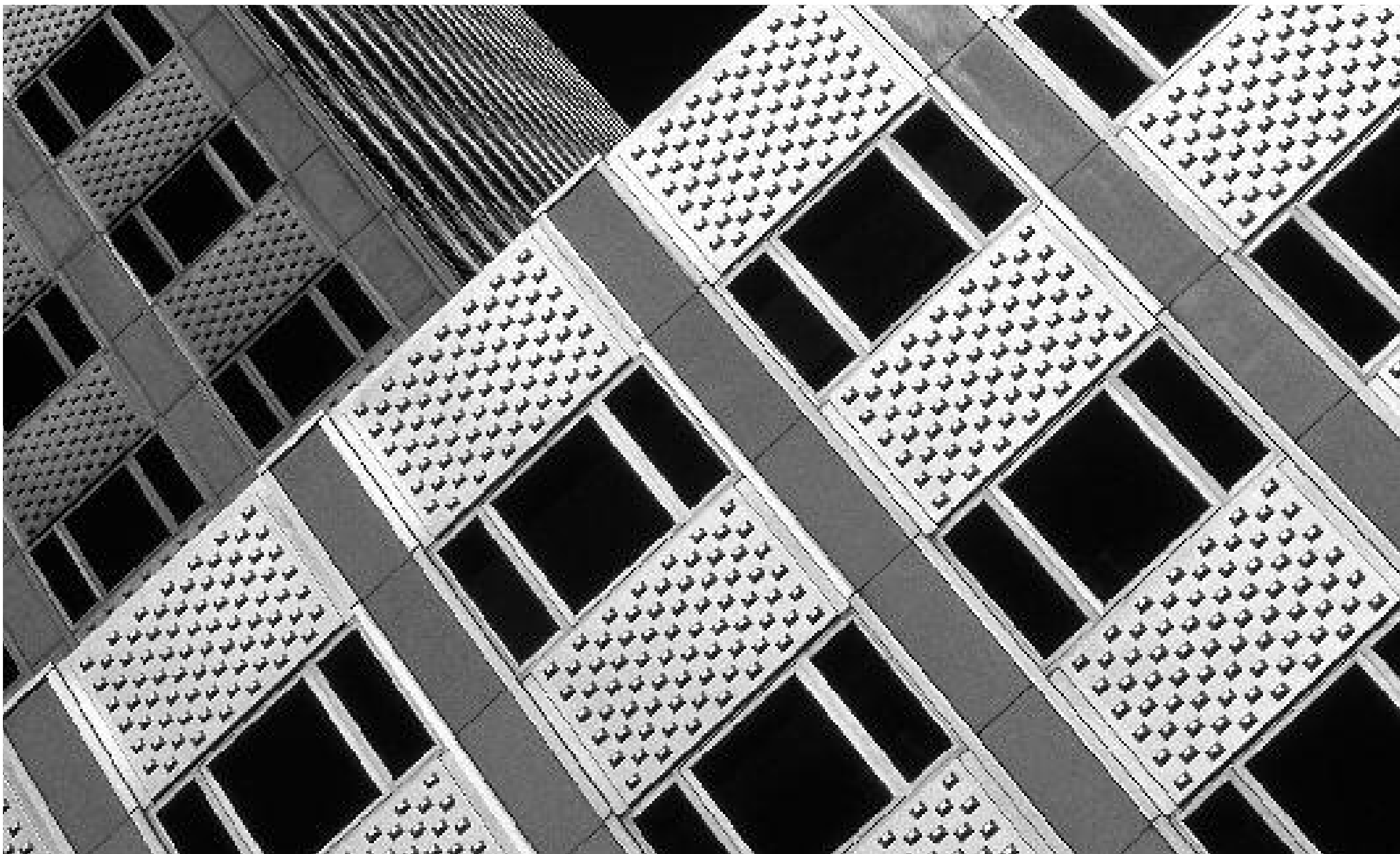
Tax

The tax consequences of using these investment vehicles depends on the status of the individual investor (for example their tax residence and domicile), the particular features of the vehicle (it may be based offshore) and the possible application of various anti-avoidance tax laws. Thus, investors should always seek tax advice based on their particular facts and circumstances.

Many of the rules are currently being reviewed and could change. In particular, each Budget could affect the tax rates and the tax consequences arising from the various vehicles.

Inheritance tax will be relevant to most of the investment vehicles, so investors should also seek advice on this.

The notes on taxation of the various investment vehicles covered in p18-25 assume a UK tax resident and domiciled individual. The tax rates quoted are those in force for the tax year 2006/07.



6 How can individuals invest in commercial property?

Until recently, there were only a limited number of ways in which individuals, particularly those with small amounts of capital, could invest in commercial property. This is changing rapidly. Below we discuss the main vehicles that are currently available.

UK authorised property unit trusts

Authorised property unit trusts can invest up to 100% directly in property and the manager is entitled to defer redemptions by up to six months. APUTs can also invest up to 20% of their assets in unregulated collective investment schemes, such as limited partnerships or unauthorised unit trusts. There are now around 20 authorised unit trusts specialising in commercial real estate. UK APUTs can now be included in ISAs.

The Government is considering the tax position of APUTs, which are currently subject to tax on income at 20%. UK real estate investment trusts (REITs) introduced on 1 January 2007, are exempt from tax on income and capital gains from investment property (see p19), and the property industry has campaigned for APUTs to be given tax parity with REITs.

TAX BRIEF (non-ISA funds)

- The unit trust itself is exempt from tax on capital gains but pays corporation tax at a special rate of 20% on its income profits (after deducting allowable expenses)
- The sale of units in an authorised property unit trust is subject to capital gains tax with non-business asset taper relief available
- Unit holders are generally taxed on distributions from the unit trust in the same way as on a dividend from a UK company. For basic rate tax payers, the tax credit will discharge their income tax liability in full. Higher rate tax payers will be liable to tax at 25% of the net distribution
- Transfers of units in an authorised (and unauthorised) unit trust are potentially subject to stamp duty at up to 0.5%

Unauthorised property unit trusts

Key point: UK unauthorised property unit trusts are available for tax exempt investors. Other tax-efficient ones are domiciled offshore.

There are many unauthorised property unit trusts. Most of these are set up to provide an efficient vehicle for tax-exempt investors, such as pension funds and charities. These unit trusts give them exposure to property without the management burden and illiquidity of a direct holding.

The unauthorised unit trust structure is also used as a feeder fund allowing other tax-exempt investors, such as SIPPs, to participate in vehicles like limited partnerships.

There are also unauthorised property unit trusts which are available to non-exempt investors. These are domiciled offshore mainly for tax reasons (usually in Jersey or Guernsey), and are governed by local regulators, with a local manager.

Like onshore unauthorised property unit trusts, these offshore funds cannot be marketed directly to the general public in the UK. However, they are usually available to high net worth individuals.

TAX BRIEF

- The unit trust pays 22% tax on gross income and also pays tax on capital gains unless it falls within stated exemptions (for example all unit holders are UK resident but exempt from UK taxes). Most expenses are not deductible in computing taxable income
- An offshore unit trust investing in UK property will be taxed at 22% on net rental income but is exempt from tax on capital gains
- For unit holders, the tax position is the same as if investing in an authorised unit trust
- Transfers of units in an offshore unit trust should not attract stamp duty

Unit-linked life and pension funds

More than 20 life insurance companies have unit-linked life and/or pension funds that invest directly in property. Unit-linked pension funds are typically part of a range on offer to investors in occupational or personal pension schemes. Unit-linked life funds are accessible to individuals through either lump sum ('investment bonds' – see below) or regular savings products.

The longer-term nature of these products allows the funds to operate with less of their assets in cash than authorised unit trusts.

UK life bonds

Life bonds or investment bonds are life insurance policies, typically purchased with a single premium which is invested in either a with-profits fund or unit-linked life funds. Because they are life insurance policies, tax on withdrawals from the policy can be deferred.

Any profit on disposal of the bond is taxable as income for the investor. For higher rate tax payers, the gain is charged at 40% but the individual is treated as if they have already paid tax at 20% on it, resulting in a 20% tax charge on the gain. If the individual is not a higher rate taxpayer there should be no tax to pay on a disposal of the bond.

TAX BRIEF TAX BRIEF TAX BRIEF TAX

- The bond holder can generally withdraw 5% of their initial investment annually without any immediate tax charge. However, the tax is only deferred, because these intermediate withdrawals are taken into account when calculating the gain on the ultimate surrender of the policy
- No stamp duty is charged when the bond is either issued or surrendered for cash. However, stamp duty can arise in other situations

Real estate investment trusts

The label real estate investment trusts, or REITs, applies to several different property investment vehicles in various countries. However, they share a common feature: that they generally own and manage income-producing property, distributing most of their income to shareholders through dividends. In return, the REIT is largely exempt from corporation tax.

In the United States and Australia, there are well-established and significant REIT sectors that offer small private investors access to an asset class they otherwise would not be able to enter.

For example, there are now more than 200 quoted REITs in the United States. The sector has a market capitalisation of $475bn and is included in Standard & Poor's major stock market indices. Other countries, including France, Japan, and Singapore, have recently introduced REITs.

The UK version of REITs was launched on 1 January 2007. It takes the legal form of a UK company with a special tax status and most of the UK's larger quoted property companies will be converting to REITs. In time, UK REITs are expected to form a significant sector in their own right.

Provided they meet certain conditions, UK REITs are not taxed on their income and capital gains from investment properties. As a result, most of the income and gains can flow directly to shareholders, free of tax. Shareholders are then taxed according to their own circumstances.

Distributions from a UK REIT can either be normal company dividends or property income distributions (PIDs) depending on the source of profits from which they arise. Broadly, PIDs are distributions out of the qualifying tax-exempt property investment activities and are subject to withholding tax at 22%. However, certain overseas investors are entitled to reclaim some of this tax under international double tax treaties. For tax exempt investors, (such as pension funds) and certain specific classes of investor including ISAs, PEPs and CTFs, PIDs from a REIT are paid gross, without deducting tax at source.

This is in contrast to the normal corporate format, under which tax-paying investors in property companies suffer double taxation. First, the company pays corporation tax on the rental income from its properties and any capital gains arising. Then the investor pays tax on dividends received, with very limited credit for the corporate tax.

However, to qualify for their special tax status, a UK REIT must meet certain conditions:

- It must be UK tax resident
- It must be listed on a 'recognised stock exchange', with the shares widely held. (This includes, for example a full LSE listing, but not AIM)
- It must not be an open ended company

There are also further conditions which do not necessarily result in immediate removal from the REIT regime.

- It must have a simple share and loan capital structure
- At least 75% of its income must be from rents and 75% of its assets must be investment properties. Owner-occupied property does not qualify
- It must hold at least three investment properties, though the definition of property includes separate rental units within one building
- No single property may represent more than 40% of the total portfolio value

It is important to note the following:

- Income from non-property investment activities is taxed at the usual corporate rate of 30%
- Development for investment is allowed

The definition of property is quite widely drawn. There are no restrictions on the types of real estate that can be included. However it is not yet clear whether the properties used by certain kinds of businesses, like hotels, self-storage, or nursing homes, would qualify as investment rather than operational properties.

In addition, REITs will suffer tax penalties if they either:

- Pay dividends to corporate shareholders with 10% or more direct or indirect shareholding. This is aimed at preventing tax leakage, since substantial shareholders, may otherwise be able to reclaim all of the tax withheld at source
- Allow gross income to be less than 125% of interest
- Fail to distribute 90% of its income profits from its property investment activities. There is no obligation to distribute capital gains

To convert to REIT, companies must pay an 'entry charge' of 2% of the market value of their investment properties. In return for this up-front payment, UK REITs are effectively able to eliminate any historic contingent capital gains on these properties and reduce their tax liabilities on income and gains going forward.

Newly established companies will have a one year grace period during which they do not have to satisfy the special 75% income and asset test to become REITs. This allows new REITs to be set up without paying the 2% conversion charge until the end of the initial 12-month period.

Most of the larger UK property companies who qualify for REIT status have announced they will be converting. Others, including those who think their business model is strong enough and those who have significant trading activities, have decided they will keep their current format. And a third group is keeping their position under review and may convert later.

At present, REITs are at the start of their development. With time, the codes governing their operations are likely to evolve and change, so advisers should keep them under review.

UK property companies

Key point: Some property company shares offer liquidity but they exhibit high volatility and suffer tax leakage.

The introduction of tax-efficient real estate investment trusts in 2007 will radically affect investment in UK listed property companies.

There are currently around 40 public property companies listed on the main London Stock Exchange and 70 on AIM, the Alternative Investment Market. Historically, their shares have often traded at a discount to the net asset value of the underlying property portfolios. Property companies' share prices are also usually more volatile than the value of the underlying assets.

In addition, non-REIT property companies are not tax-efficient vehicles. This is because tax-paying investors generally suffer double taxation, as described earlier.

Moreover, tax-exempt investors such as pension funds and charities also end up suffering tax because they cannot reclaim the corporation tax paid by the company. This is one reason why they often prefer to invest in commercial property directly or in tax-transparent vehicles such as limited partnerships or unauthorised unit trusts.

TAX BRIEF TAX BRIEF TAX BRIEF TAX

- The company itself is subject to tax on income and capital gains at 30%. Certain small and medium-sized companies may benefit from lower rates
- Stamp duty is levied at 0.5% on share acquisitions
- A disposal of shares attracts capital gains tax with non-business asset taper relief available. If the investor works for the company and various other conditions are met, more favourable business asset taper relief may apply
- Basic rate taxpayers pay no further tax on dividends; higher rate tax payers pay an effective rate of 25%

Investment trusts

A UK investment trust is an HM Revenue & Customs-approved investment company listed on the London Stock Exchange. Approval means that the investment trust is exempted from tax on capital gains. The rules require that the trust derive its income mainly from securities or from 'eligible' property. But in this case, eligible property means let dwelling houses. Because of this restriction on their income source, most investment trusts do not invest directly in commercial property.

TAX BRIEF TAX BRIEF TAX BRIEF TA

- A disposal of shares is normally subject to capital gains tax with non-business asset taper relief available
- Basic rate taxpayers pay no further tax on dividends; higher rate taxpayers pay an effective rate of 25%
- Stamp duty is charged at 0.5% on acquisitions of shares

Offshore UK-listed property companies

Key point: Offshore property companies can be complex but may offer tax benefits for investors.

In recent years, companies have been set up in other legal jurisdictions, notably the Channel Islands, to create specialist closed-ended investment funds. By listing these companies on a recognised exchange (as defined by the FSA's rules), product providers can sell directly to private investors in the UK. In all cases, providers have also obtained a London stock market listing for the company.

TAX BRIEF TAX BRIEF TAX BRIEF TAX

- As a non-UK resident, the company is not subject to capital gains tax on UK property, provided it is an 'investor' rather than a 'dealer' (see p29). It is subject to UK income tax at 22% on rents (less allowable expenses) from UK properties. Other tax consequences may arise in the jurisdiction of residence
- Capital gains tax is charged on disposals of shares generally with non-business asset taper relief
- Purchases of shares are not subject to stamp duty unless the shares are registered in the UK
- Dividend income is taxable at 32.5%. A credit for tax paid by the company in the overseas jurisdiction may be available, depending on any double tax treaty. This assumes that the income within the company is not subject to income tax on the shareholder as it arises, under UK anti-avoidance legislation
- Anti-avoidance rules may impute the capital gains of the company to shareholders who are UK resident and domiciled if they have more than a 10% interest in the company, and if it is controlled by five or fewer participants. These rules are complex and are designed to prevent individuals from realising tax-free profits by owning assets in a corporate wrapper, in a tax haven

Offshore investment company with variable capital

Key point: Offshore investment companies with variable capital seem complex but can offer tax efficiency and some liquidity.

Dublin-listed investment companies with variable capital are an attractive structure for some funds because of the flexibility possible in investment objectives. A few funds specialising in UK commercial property have been set up using this format.

TAX BRIEF TAX BRIEF TAX BRIEF TAX

- Capital gains tax is charged on disposals of shares generally with non-business asset taper relief
- For higher rate taxpayers, dividends are taxed at 32.5%

UK limited partnerships

Key point: Limited partnerships offer tax transparency and are usually geared, but can be high-risk and illiquid. They are not efficient from an SDLT perspective.

Until the Finance Act 2004 came into force, limited partnerships were popular with institutional investors as a vehicle for co-owning property. This was mainly because limited partnerships are tax transparent and can be leveraged. This means that an investor is treated as if he owned his share of the assets and liabilities directly.

However, the imposition of stamp duty land tax (SDLT) on the transfer of partnership interests is a significant obstacle to liquidity, particularly for larger interests.

Several specialist product providers have used limited partnerships to structure property-based investments for private investors. In addition, SIPP and SASS investors have been able to participate through exempt property unit trust feeder funds.

However, interests in limited partnerships and feeder funds (if any) are unregulated collective investment schemes and thus may only be marketed to investment professionals and certain other high net worth

companies, trusts and associations. In practice, many products have been marketed through IFAs. The minimum investment threshold is usually £25-50,000.

The introduction of UK REITs in 2007 is likely to impact on the use of limited partnerships for commercial property investment, because REITs are not only tax-efficient, but more liquid.

TAX BRIEF TAX BRIEF TAX BRIEF TAX

- The partnership agreement will determine a partner's entitlement to income and capital gains. Each individual partner is taxed as though having a direct investment in their share of the partnership assets
- The partnership itself is tax-transparent so there should be no tax levied on the vehicle itself
- Stamp duty land tax at up to 4% applies to the acquisition of a partnership interest. The amount due is based on the value of an investor's share of the underlying property asset(s)
- The VAT treatment of a transfer of an interest in a property partnership is not straightforward and will depend on the circumstances

Derivatives

Real estate derivatives are financial instruments which give investors a return that reflects the performance of the direct property market. They are an emerging market in the UK aimed at institutional investors and high net worth individuals.There are also some residential real estate derivatives.

The plus point of derivatives is that they allow investors to buy or sell real estate exposure easily, cheaply and quickly. Stamp duty is not payable on property derivative transactions, provided the instruments are structured so as to give no rights or interest in the land, other than the security interest. However, liquidity is an issue. Though the volume of trades is rising, an active secondary market has not yet developed.

The derivatives currently available include:

- Property income certificates. PICs are Eurobonds, so technically speaking they are bonds rather than derivatives. But they pay investors a quarterly return based on IPD's all-property total return. On maturity, investors receive the face value of the bond adjusted for movements in the index over that time. A bond with an embedded property swap, they are issued sporadically. Barclays and Protego run a secondary market, with indicative prices displayed on Reuters. The minimum investment varies from £1,000 to £100,000
- UK IPD index tracker. Launched by Goldman Sachs in 2006, this structured product pays investors the total return earned by UK commercial property as registered by IPD's annual index, minus 2.8%. The warrants, which expire in 2011, are listed in London, allowing daily trading. The minimum investment is £10
- IPD index swaps. These are over-the-counter trades, arranged by banks. Investors swap LIBOR plus a margin in exchange for property returns as measured by IPD's annual index. They are mainly for professional investors, since they involve substantial amounts of capital. Most swaps have featured the total return on all property but trades are emerging on component sectors and subsectors of the IPD index, such as offices and shopping centres, and between sectors

Over the two years to December 2006, there have been a total of 333 trades in the above products, with a total notional value of £4.65bn.

Direct investment

Key point: Direct investment requires large amounts of capital.

It is, of course, possible to invest in property by buying buildings directly. As noted earlier, private investors have recently become a significant force in the market. However, direct investment is not an option for most people because of the very large price tags attached to most commercial real estate.

Because of these large lot sizes, some investors have clubbed together or formed syndicates to buy properties. This is a specialist area and should not be embarked upon without suitable advisers.

Investing directly also carries a significant concentration of risk. This does not necessarily rule it out, if the risk is well understood, but it requires careful consideration.

TAX BRIEF TAX BRIEF TAX BRIEF TAX

- Individuals pay tax on rental income at their marginal rate after deducting allowable expenses, such as interest on borrowings to finance the investment, or capital allowances
- Capital gains tax applies to gains on the disposal of the property. Taper relief is available, but whether this is at the preferential business asset rate depends on factors such as the building's use and, if it is leased, the status of the lessee. The comments on 'property dealing' should also be considered (see p29)
- Stamp duty land tax applies at up to 4% on acquisition of the property
- Whether VAT is chargeable depends on the VAT status of the property, so this needs to be verified

SIPP investment

Key point: SIPP investors can gain exposure to commercial property in several ways but the rules are changing, so seek specialist advice.

It is possible to invest in commercial property via a Self Invested Personal Pension (SIPP). Tax-exempt property unit trusts are often structured as feeder funds into other products, like limited partnerships, in order to give SIPP investors access to them.

It is even possible for a SIPP to invest in a building that is occupied by its beneficiary's business. For example, the owner of a small business can invest his SIPP in the office building which it occupies.

However, these arrangements are subject to strict criteria and must be done on a commercial basis, that is, the rent paid must be a market rent.

Moreover, since April 2006 SIPPs can invest in residential property via designated vehicles, including UK REITs and collective investment schemes. However, direct investment in residential property is taxed punitively.

At present, SIPP investors can borrow up to 75% of the purchase price, but from April 2006 the scope to use debt is restricted to 50% of the fund, unless it is categorised as a 'genuinely diverse commercial vehicle'.

It is also possible to form designated SIPP syndicates to buy property via a SIPP. Specialist advice should be obtained for this.

TAX BRIEF TAX BRIEF TAX BRIEF TAX

- The normal age-related rules apply to the level of annual contribution to the scheme that can be made benefiting from income tax relief
- The rules on drawdown of funds are complex. Broadly, 25% of the fund can be extracted on retirement tax-free. The remainder is used to buy an annuity, the income from which is subject to income tax
- The pension fund itself is exempt from tax on income and capital gains

Property syndicates

Key point: Check whether a property syndicate is FSA regulated and if not make the investor aware of this.

Investors can buy commercial property directly via syndicates. Although they are legitimate mechanisms for getting exposure to real estate, some property syndicates have been subject to abuse, most notably by promoters of off-plan investments in the residential sector.

Most property syndicates are not collective investment schemes for regulatory purposes. Therefore they are not covered by the investor protection provisions contained in FSMA 2000.

TAX BRIEF TAX BRIEF TAX BRIEF TAX

- Individuals pay tax on rental income at their marginal rate after deduction allowable expenses. For higher rate taxpayers, the rate is 40%
- Capital gains tax is levied on disposal of properties at a gain. Business asset taper relief may be available depending on the status of the properties and their use. Otherwise non-business asset taper relief rates will apply
- Stamp duty land tax is payable at up to 4% on the acquisition of properties

7 The Risks

Property risk

Location

The adage of 'location, location, location' holds true. The siting of a building is crucially important in determining its market value. A property investment is likely to be held for several years and the attractiveness of its location can change over the holding period, for better or worse. For example, where an urban area is being regenerated, the perception is that the location is likely to improve. In contrast, a major new shopping centre development may diminish the appeal of existing shops nearby.

Physical characteristics

Similarly, the type and use of the building will affect its value. By type we mean what sort of building it is, i.e. an office or shop. Utility refers to the benefits an occupier gets from using the building. This is difficult to measure but things that affect utility are the location and the quality of the building, which covers the materials, internal layout and specification.

The risk factor is depreciation. All buildings suffer wear and tear, but advances in building technology or tenants' requirements may also make buildings less attractive over time. For example, the specifications for new buildings have changed because of the large amount of under-floor cabling needed in modern offices.

Tenants

The value of a building also depends on the rental income it can produce for its owner. However, it is not just the risk of an outright default that matters. If the credit quality of the tenant deteriorates materially during the period of ownership, then the building's sale value is also likely to go down.

Lease length

The length of the leases is also an important consideration. If a building is let to a good quality tenant for a long period then the rental income is assured, even if market conditions for property are volatile. This is one of the attractive features of property investment.

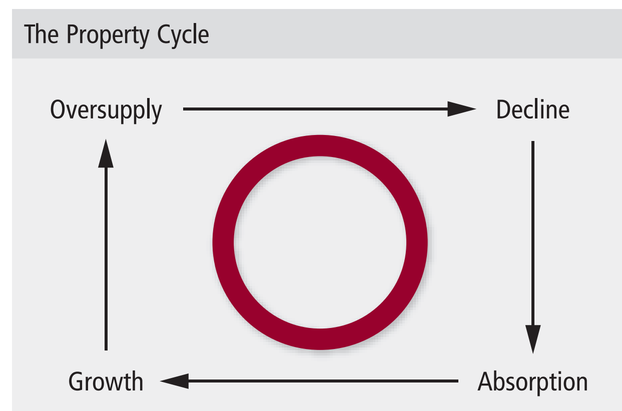
Thus, when buying a property, it is important to consider what the lease length will be when the property is likely to be resold. Many leases include break options and it is market practice to assume that the lease will finish at the break point.

Market risk

Market yield

These are risk factors that can affect all, or significant sections of the property market. Like the economy, commercial property appears to go through cycles: periods of growth leading to oversupply and market weakness, followed by stabilisation, absorption and then growth, leading to shortage of supply and so on.

The Property Cycle



The simplest yardstick of property value is initial yield. This is the current annual rent divided by the value of the property, including purchase costs.

The average initial yield across the whole property market fluctuates over time and may reflect the general economic cycle and/or specific changes in attitude towards property.

Example

Annual rent = £1m

Property value plus costs = £12.5m

Initial yield = 0.08 (8%)

The level of interest rates in the economy affects the average initial yield. Currently, property initial yields are relatively low compared to historic levels, given the low levels of interest rates. However, this low level of yields may also reflect a re-appraisal of the investment merits of property, which has been neglected by broad swathes of institutional investors for many years. Any investor in property faces the risks of initial yields rising, and therefore value decreasing, either because of a rise in interest rates or for other reasons. In a recession general risk premia rise, so property yields could rise even if interest rates did not rise.

Sector risk

In addition to general market factors, every property is part of a particular business sector, i.e. it is a shop, an office or a warehouse. Sectors can and do perform differently from the market as a whole, similar to different business sectors of the equity market.

Thus, in 2005, average total return for the property market as a whole was 19%. Within this, offices outperformed, returning 20.4% while industrials generated 18.4%. These numbers are averages and some offices will have performed much better than some industrial units, but there are undoubtedly sector effects.

Rental growth

The value of any financial asset can be construed as the discounted value of its future income stream. In equities, the income stream comes as dividends; in property it is the rental income.

Example

Current rental income = £1m
Inital yield = 8%

Value = Rent/yield = £1,000,000/0.08
= £12,500,000

If rental income grows to £1.2m
Value grows to £15,000,000

The value of a property will reflect market expectations as to the growth of its rental income, just as equities mirror expected growth in dividend income. Changes in these expectations for rental growth will have a profound effect on the value of a property.

If an investment is made expecting that rents will grow by a certain amount and that does not happen, then the returns from that property will inevitably be lower than anticipated. And rental growth can be affected by many factors: the national economy, local trading conditions, relative scarcity of alternative space and so on.

Stamp duty land tax

There are also risks associated with the process of buying and selling a property. The principal one is stamp duty and schemes for avoiding it.

Stamp duty land tax is levied on property transactions in the UK. From 1% in 1997 it has increased to a top rate of 4%. Over this period various methods were devised to avoid stamp duty. However, starting in 2003, changes to the tax regime have closed many of these loopholes. Moreover, historical purchases of properties in stamp duty savings schemes may involve some residual risk, in that HM Revenue & Customs may attack these schemes retrospectively and could even levy penalties.

Product risk

Most property investors will use a vehicle or product, such as a unit trust or limited partnership. These can help reduce the risk of investing, but in some cases the structure itself can bring additional risks.

Liquidity

Direct property investments are relatively illiquid compared to most bonds and equities. Liquidity depends on both the time needed to transact a sale and how easy it is to trade at the market price. In normal market conditions, commercial property is slow to transact and hence illiquid. In a poor market it will take even longer to find a buyer and it may not be possible to find a buyer at all at an acceptable price.

Of the indirect investments available, listed property company shares and REIT shares, are the most liquid. Being equities listed on public stock exchanges, they are continuously priced in real time and, in normal market conditions, can be traded quickly.

In the rest of the indirect market, there is currently only a very modest amount of secondary trading. In normal market conditions, however, these indirect investments are also more liquid than a direct investment because the fund manager will be able to accommodate modest sales easily.

In a more difficult market and/or when many investors want to sell at the same time, the fund manager may require investors to wait several months to get their money back. Note also that this risk can work in reverse: some unit-linked property funds have put a brake on new investment when they have received large inflows of cash and have not been able to purchase suitable assets.

HSBC (and several other parties) make a secondary market in PUTs, but institutional fund managers currently dominate activity. Due to the expansion of the sector, the rates of turnover in PUTs are relatively low at around 10% to 20% p.a. Interests in limited partnerships trade infrequently and there have been only a handful of secondary transactions. In general, managers will try to match bargains, but investors should not assume that a suitable match can be made.

Diversification

As previously noted, an investment in a fund that holds many properties will be less risky than in a single property because the fund benefits from having spread its risks. Sectoral and geographic spread also mitigates risk.

Price volatility

Investment in listed property companies, REITs, and other quoted property vehicles will, in general, provide the investors with risk reduction benefits through diversification. These vehicles also provide the investor with liquidity because the shares can be sold.

However, the shares may be more volatile because of real-time market pricing and changes in investor sentiment and they may trade at a discount to net asset value. To date though, the new offshore-domiciled, UK-listed companies trade at a premium.

Geared investments

Geared vehicles such as unit trusts and limited partnerships expose investors both to more risk and potentially higher returns, particularly where the gearing level is 70% or higher.

Gearing Example of Enhanced Income

100% Equity		**25% Equity**	
100% Equity		25% Equity (75% geared)	
		Debt (@ 5.5%)	£0.75m
Total purchase price	£1m	Total purchase price	£1m
		Rental income	£80,000
		Debt cost	£41,250
Rental income	£80,000	Net rental income	£38,750
Ungeared income return p.a.	**8.0%**	**Geared income return p.a.**	**15.5%**

Note: Simplified model ignoring costs.

If a geared vehicle is invested in a single property, the risk is concentrated. However, it may be mitigated by, for example, having a high quality tenant since this would lower the risk of default on the rental income stream used to secure the loan.

When assessing the risk inherent in a geared vehicle, there are five important points to consider:

- Credit worthiness of the tenant
- Length of the lease
- Investment horizon
- Term of the loan
- Assumed rental growth

These investments will run into serious difficulties if the tenant fails to pay the rent. Although the partnership could re-let the building, it would almost inevitably default on its loan payments before it was able to do this. This would mean that investors would lose money, possibly a substantial part of their capital.

For an ungeared vehicle, tenant default is not terminal because it can relet the building.

Gearing Example of Magnified Capital Loss			
100% Equity		**25% Equity (75% geared)**	
Equity	£1m	Equity	£0.25m
		Debt (@ 5.5%)	£0.75m
Total purchase price	£1m	Total purchase price	£1m
Rental income p.a.	£80,000	Rental income p.a.	£80,000
		Debt cost p.a.	£41,250
Sale price after 5 years	£0.8m	Sale price after 5 years	£0.8m
Ungeared return p.a.	**4.3%**	**Geared return p.a.**	**-0.7%**

Note: Simplified model ignoring costs.

Tax risk

It is important that anyone investing in property, whether an individual or a vehicle, does not ‘deal’. This is because profits from selling the property are then taxable as income rather than capital gains.

There are many factors that determine whether an asset is held as an investment or for dealing, but the key distinction is whether the property was bought with the intention of selling it on, probably within a fairly short period, at a profit.

For those investment vehicles that are exempted from capital gains tax, this is clearly critical because they have to pay tax on income gains. For direct investment, including investment through a limited partnership, dealing could also mean losing taper relief and the annual capital gains allowance.

The status of a vehicle as a property investor should be established. For individuals investing directly in property, it is important they understand the tax consequences of dealing versus investment.

Sources of further information

Category	Name	Website
Property industry bodies	British Property Federation	www.bpf.org.uk
	Investment Property Forum	www.ipf.org.uk
	RICS	www.rics.org.uk
Property data sources	Investment Property Databank	www.ipdglobal.com
	Property Data	www.propertydata.com
Independent comment	Estates Gazette	www.egi.co.uk
	Property Week	www.propertyweek.com
Real estate funds	Association of Real Estate Funds	www.aref.org.uk
	European Association for Investors in Non-listed Real Estate Funds	www.inrev.org
	European Public Real Estate Association	www.epra.com
	The REITS and Quoted Property Group	www.reita.org

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