COMMERCIAL PROPERTY INVESTMENT

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Property as an asset class is usually divided into two main types – **commercial** and **residential**. Although residential and commercial property investments tend to be related to the overall performance of the economy in the long term, they generally display **very different investment characteristics**.

Here we look at whether you should, and how you can, add **commercial** property investments to your portfolio, and the tax implications should you decide to invest directly.

Please refer to our note on Risk and Asset Allocation for a discussion on how to determine the level of risk you should take, and consequently the proportion of investments in each asset class which might be suitable for you.

SUMMARY

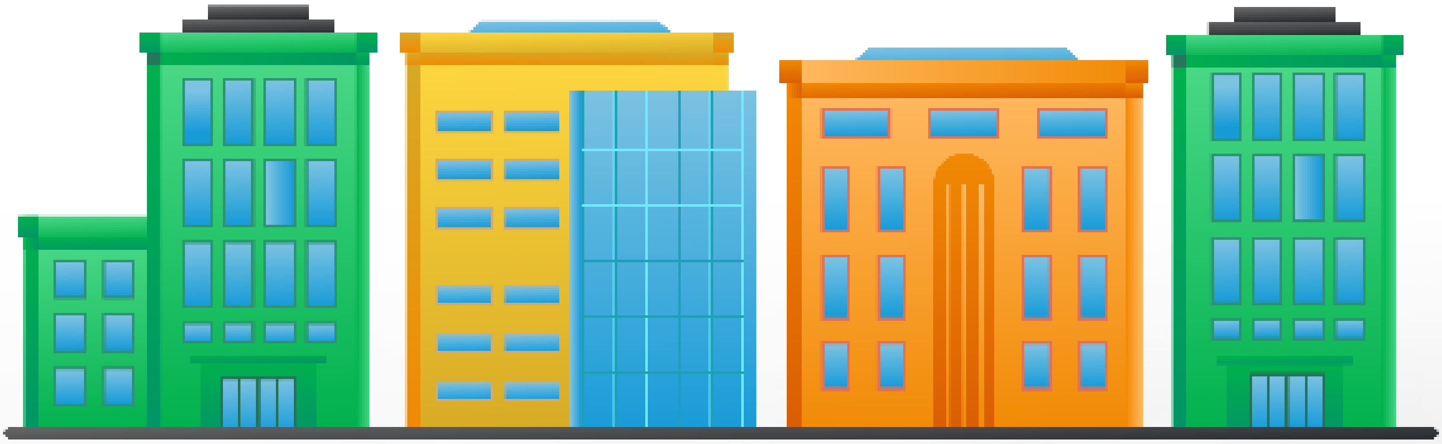
Commercial property investment generally refers to investment in **office, retail or industrial property**. There are two components of potential return - **rental income** and **capital growth**.

As with equities and fixed interest investments, there is usually a place for commercial property investment in some proportion in most long term investment portfolios, as this can provide **useful diversification** from other asset classes.

In terms of investment risk, commercial property is usually seen as being somewhere between corporate bonds and equities – providing the **potential for a relatively secure income stream with future capital growth**. As with all classes of investment, there will be individually varying and overlapping levels of risk within these classes.

Although residential and commercial property investments tend to be related to the overall performance of the economy in the long term, they generally display very different investment characteristics. Hence even investors with large existing exposure to residential property (e.g. through their home) may find there is a place in their portfolio for commercial property.

In practice **most individuals obtain exposure to commercial property by investing in Unit Trusts, OEICs or Investment Trusts** investing in a range of properties and property company shares. It is also possible for individuals to buy commercial property directly through certain types of pension scheme - Self Invested Pensions Plans (SIPPs) and Small Self Administered Schemes (SSAS). In addition, there are more specialist methods of investing in commercial property, which may be worthy of consideration for investors with larger portfolios and a higher appetite for investment risk.

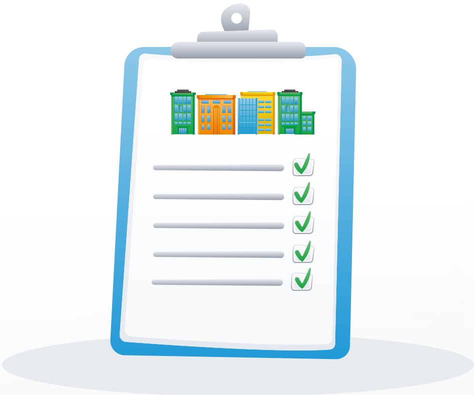


BACKGROUND

Commercial property investment performance is closely related to the profits of business, and is regarded by some as a substitute investment in business. However, rents may not follow profits closely in the short term, as rental income tends to provide a smoother cash flow than profits. Historically, long leases with upwards-only rent review clauses have been used to give landlords additional security, but these may decline in popularity in the future as flexible office service providers offer a competitive product.

Capital values will vary as a multiple of rental values, but will also change with market expectations of future growth (i.e. a high multiple (low yield) reflects an expectation of strong future growth and reasonable security).

A further important consideration is the quality and surety of the tenant – a property with a financially secure tenant is likely to be more highly valued than the same property without any tenant.



GENERAL ADVANTAGES OF PROPERTY INVESTMENT

- Property is an asset backed investment, and so tends to keep pace with inflation over the longer term. Of course, this does not mean that all property is a guaranteed hedge against inflation, as local factors (location/industry/quality of tenant) will also affect valuations.

- Gearing is a readily acceptable method of investing directly in property, which will magnify gains and losses, and can be tax-efficient (offsetting the loan interest against rental income). For example, gearing can be used for larger and more direct commercial property investment through a SIPP. It generally does not apply to investment through a collective investment vehicle (e.g. OEIC/UT).

- Property is familiar and tangible, and hence many investors prefer this form of investment. However, investors should be careful not to overweight themselves in this asset class.

BACKGROUND

GENERAL DISADVANTAGES OF PROPERTY INVESTMENT

- Property can be a highly illiquid investment and delays in selling can be high.

- The costs involved with investment can also be high – e.g. costs of purchase (stamp duty, legal fees), sale, and ongoing costs of management if the investor does not have the time or expertise to manage the property themselves. In addition, property needs to be maintained. All of these costs will reduce the net return (capital and rental yield) achieved.

- It can be difficult to achieve a sufficiently diversified property portfolio for all but those with the largest portfolios. Direct investment in just one or two properties means that the investor is highly exposed to specific risks such as defaulting tenants, environmental risks, structural problems and the local economy – resulting in a much higher risk portfolio. For this reason, the majority of investment into this asset class tends to be through collective investment vehicles (e.g. unit trusts, OEICs, investment trusts), where a relatively small investment (e.g. £500) can enable access to a widely diversified and professionally managed portfolio.

- There may be 'void' periods where a tenant cannot be found, further reducing the net rental yield achieved.

- As property cannot generally be partially sold, it can be difficult to manage the crystallisation of capital gains over a number of years (e.g. in order to use the annual exemption). Again, investment via a collective investment vehicle can help to provide additional liquidity. Please note, however, that most unit trust/OEIC fund managers do reserve the right to delay encashment of units for a certain period (e.g. up to 6 months), as the underlying investments are still relatively illiquid.

- Long term performance statistics show that equities have generally outperformed property (see the separate Research Note on Asset Allocation - Risk and Return). Again, a well balanced portfolio will usually contain elements of all the major asset classes in order to optimise the risk/return profile.

METHODS OF INVESTING IN COMMERCIAL PROPERTY

As mentioned above, it can be difficult for all but those with the largest portfolios to gain a sufficiently diversified property portfolio, in balance with their other assets. There are a number of different ways to invest in property other than through direct purchase and some of the main areas are outlined below.

INVESTMENT IN PROPERTY COMPANIES

One option is for the investor to buy shares in a selection of property companies, thereby exposing the investor to specialist management and quality property portfolios. The principal drawback of this type of investment is that the share value of property companies may trade at a discount or premium to their net asset value, and so investment performance will also be affected by market sentiment. The investment volatility is therefore likely to be similar to equity investment – thus reducing the diversification benefits of investing in a separate asset class. It is also worthwhile highlighting the disadvantage of double taxation, where the company pays corporation tax on any gains/income, and in addition the investor pays capital gains tax/income tax.

PROPERTY PARTNERSHIPS

Some investors would like to own single asset properties but the scale of investment required usually makes this impractical. A number of promoters have set up larger commercial property investments through partnership arrangements. The benefits are that the investor can invest in a portion of a tangible property, with a known tenant, without having to go through a lot of the administrative inconveniences that individual property ownership provokes. In addition, the promoter will usually put in place a borrowing facility so that the investor buys an already geared percentage of the value, without having to arrange the debt himself.

LIFE COMPANY FUNDS

A number of providers have property funds, which can be invested in through their pension and life assurance contracts. These funds will be invested in commercial property and are often very large indeed. However, the investor must be clear on the rules and restrictions surrounding the chosen 'wrapper' (i.e. pension or life assurance policy). Please see our separate Research Notes on these areas for further details.

METHODS OF INVESTING IN COMMERCIAL PROPERTY

PROPERTY COLLECTIVE INVESTMENT VEHICLES – E.G. REITS/UNIT TRUSTS/OEICS

This is the method most frequently employed by investors to overcome many of the disadvantages mentioned above – i.e. gain a diversified property portfolio for a low initial investment, with relatively low costs, little administration and relative liquidity. Please note, however, that most unit trust/OEIC fund managers do reserve the right to delay encashment of units for a certain period (e.g. up to 6 months), as the underlying investments are still relatively illiquid.

There are only a few unit trusts directly investing in property in the UK that are available for investment by individuals. Please see our Buy List for further details of suggested funds for consideration. These funds can also be held within an ISA wrapper. In addition, there are also a very few investment trusts investing in property, but investors should be aware of the additional risks of investing in this type of collective investment vehicle (please see our Research Note on Investment Trusts for further details).

Real Estate Investment Trusts, or REITs, are another type of tax efficient collective investment vehicle investing in commercial or residential property. The REIT structure protects the company from corporation tax, in return for an undertaking to distribute at least 90% of rental yield out to shareholders within 12 months of receipt. REITs are also qualifying investments for ISAs. As a REIT is a closed ended fund, the share price may trade at a discount or premium to the net asset value of the underlying holdings, and so may be more volatile than a direct property holding. Investors who currently do not feel that a direct property investment is suitable or possible for them may therefore be able to gain additional exposure to the property market through these diversified vehicles. Individual REITs may be concentrated in certain sectors (e.g. property development, or commercial property such as London offices), so a single REIT investment may not offer the level of diversification required.

METHODS OF INVESTING IN COMMERCIAL PROPERTY

OFFSHORE PROPERTY FUNDS

Offshore property funds are not constrained by the FCA rules governing onshore property unit trusts and are therefore able to offer a broader range of investment strategies to UK based individuals. For example, specialising in commercial property, healthcare and leisure property, freeholds and retirement property.

These schemes are structured as unauthorised OEICS, and as such fall outside the provisions of the UK investors' compensation scheme arrangements and caution should be exercised appropriately. They will usually price on a monthly basis in contrast to the daily pricing of equity-based funds. Investors will also need to bear in mind the tax position of the funds. Many offshore funds will give rise to an income assessment on profits, rather than capital gains.

Important information: Our views are based upon our understanding of current legislation in England, unless stated otherwise. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances.

Risk Warning: The past is not necessarily a guide to future performance. The value of your investment and the income from it can fall as well as rise and is not guaranteed. You may not get back the full amount invested. This document is provided for information only and does not constitute advice. You should not act on any of the information without seeking professional advice.