Understanding UK Commercial Property Investments

A Guide for Financial Advisers

2015 Edition

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Introduction

- WHY CONSIDER UK COMMERCIAL PROPERTY INVESTMENT?
- WHAT RETURNS MIGHT ONE EXPECT?
- WHAT ARE THE RISKS?
- WHAT ROUTES TO INVESTMENT ARE THERE?

This Guide is intended to provide an objective overview of the attributes of UK commercial property as a mainstream asset class and an outline of the commonly-available product structures through which investors are able to access the market, should direct property purchase not be the appropriate route.

The focus of this Guide is on commercial property rather than residential as, at present, the latter constitutes only a small part of the portfolios within both funds and property companies. It is anticipated that 'institutional' residential investment, together with that in other currently non-core, 'alternative' property sectors will become more significant in the next few years and therefore subsequent editions of the Guide are likely to be expanded to reflect these changes.

The content of this Guide relates to the UK commercial property market only. The performance of investment property in other jurisdictions may differ considerably from that in the UK for a number of reasons, not least differences in the relative size and respective liquidity of the market, the number and type of the participants and the respective valuation, legal and taxation frameworks.

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Investing in UK commercial property

PROPERTY AS AN ASSET CLASS

Pros
- Physical asset
- Relatively stable income return
- Capital growth potential
- Diversification benefits
- Risk/return profile
- Inflation protection

Cons
- Heterogeneous
- No central trading exchange (for direct property)
- Large lot size of direct property/ portfolio purchases
- Valuations, not market prices
- Transaction and management costs

INVEST?

YES

NO Invest elsewhere

INDIRECT INVESTMENT IN PROPERTY?

Pros
- Can invest smaller amounts
- Diversification benefits
- Opportunity to specialise by sector/location
- Benefit from property expertise
- No property management responsibilities
- Greater liquidity (depends on vehicle)

Cons
- Lack of control over investment decisions
- Vehicle management costs – impact on returns
- Depending on vehicle, returns may not mirror those of direct property
- Breadth of choice
- Possible lock-ins/restrictions on withdrawal

INVEST?

YES

NO Invest in direct property

CHOICE OF INDIRECT ROUTE

Investment considerations
- Listed or unlisted
- Open-ended or closed-ended
- Transparency
- Investment strategy
- Amount of investor control
- Investment performance
- Specialist sectors/locations
- Regulation/jurisdiction
- Fund tax status
- Tax on distributions
- Costs of management
- Level of gearing

Investor requirements
- Level of retail investor sophistication
- Target returns
- Need for liquidity
- Amount to invest
- UK taxpayer/non-taxpayer
- Level of control required

1: Property as an asset class

A summary of the investment characteristics of property compared with UK equities and government bonds is set out in Figure 1.

Figure 1: **Investment characteristics of the main investment types**

	Fixed-interest government bonds	Index-linked government bonds	Equities	Property
Nominal income	Fixed	Variable	Variable	Fixed, but may vary at rent review
Real income	Variable	Fixed	Variable	Variable
Nominal capital value	Fixed if held to redemption, variable if sold before	Variable	Variable	Variable
Real capital value	Variable	Fixed if held to redemption,	Variable	Variable
Nominal expected return	Fixed if held to redemption, variable if sold before	Variable	Variable	Variable
Real expected return	Variable	Fixed if held to redemption, variable if sold before	Variable	Variable
Income security	Secure (most governments)	Secure (most governments)	Depends on issuer	Depends on tenant
Liquidity	Liquid	Liquid	Liquid	Illiquid
Links to economy	Real return depends on inflation	Nominal return depends on inflation	Linked to economy and inflation	Linked to economy and inflation

Source: Martin Hoesli and Bryan D MacGregor, Property investment: principles and practice of portfolio management, 2000, London and New York: Routledge.

As an investment asset class, commercial property exhibits a number of unique features, some of which are beneficial, others less so. A clear appreciation of each is therefore essential.

1. Unique features of property as an asset class

A. PHYSICAL ASSET

Property is a tangible asset, usually comprising two elements: land and buildings. While buildings can become obsolete or destroyed, land remains an asset that generally retains some value because in the UK it is in limited supply. Furthermore, the amount of development is usually limited by the land-use planning system. Property may also offer the opportunity to increase its value, and hence investment returns, through 'active' management. This can entail such actions as refurbishment or redevelopment, the renegotiation of leases or new lettings etc.

The downside of owning a tangible asset like property is management and costs of ownership. The amount will depend on the terms of the lease. While it is common for leases in the UK to make the tenant take responsibility for all costs of repair, maintenance and insurance of the building, the landlord must still collect rent and ensure the property is adequately managed. Effective management is essential to maintain income flow and to ensure that a building remains attractive to occupiers. It should be noted that the costs of managing multi-let assets are often considerably more than for single let assets, and not all costs may be recoverable from tenants (particularly if the property is not fully let).

By contrast, share or bond ownership requires no active input from the investor, except when a decision is required to buy or sell.

'The Gherkin' – one of a kind

B. HETEROGENEITY

The heterogeneous nature of property as an investment is one of its most significant features and is both an advantage and a drawback. On the plus side, it means that an almost infinite range of opportunities exists, each providing distinctive investment characteristics. This offers the prospect for diversification, even within a portfolio of a relatively small number of properties.

The drawback is that heterogeneity can make asset pricing difficult, especially in market conditions when there are fewer transactions involving comparable investment properties. It also means that assets are inherently less liquid as price transparency is limited and each asset needs to be appraised (with asset specific due-diligence) in detail before purchase.

C. NO CENTRAL TRADING EXCHANGE

Unlike equities and gilts, there is no single market through which to buy and sell direct property investments.

The majority of major transactions are undertaken through investment agency firms, some of which are major global companies with large in-house teams of advisers and researchers. Investors may also transact directly without the use of intermediaries.

D. VALUATIONS RATHER THAN MARKET PRICES

Property performance data is based on valuations, rather than transactional data, because of the relative infrequency with which sales take place in the market. While valuation figures are based on actual market evidence, they may lag a rapidly rising or falling market to some degree, particularly if there is a lack of transactions at the time.

In a property fund, the standing external independent valuer will provide independent valuations to the fund manager, generally on a monthly or quarterly basis.

The central dome at Meadowhall Shopping Centre, Sheffield.

E. LOT SIZE

In comparison with other forms of investment, the unit cost of direct commercial property investment is very high, e.g. hardly any investment-grade office buildings would be available for less than £3m and most would cost many times more. Some property assets, such as shopping centres or offices in the centre of London, are too large for nearly all investors other than the major UK and international institutions/investors, property funds, real estate investment trusts (REITs) and property companies.

This means that investors need to have considerable funds to assemble a property portfolio that has a sufficient number of properties to be adequately diversified in itself. In practice, the only way smaller investors can achieve a balanced holding of property (if that is what is required!) is through indirect investment in property securities, funds or property. The route to indirect investment is covered later in this Guide.

F. TRANSACTION COSTS

The cost of buying and selling commercial property is significantly higher than for a comparable volume of equities and gilts. This is as a result of much higher levels of stamp duty (stamp duty land tax (SDLT)), together with the costs of lawyers, chartered surveyors, environmental surveys and the Land Registry and other fees. Further details of these costs are provided later in this Guide.

In practice, the high transaction costs associated with buying and selling property mean that property should be viewed as a long-term investment, with little or no opportunities to make short-term gains except in a rising market where the time to transact may be much shorter than the norm.

2. Size and structure of the property investment market

A. SIZE

The UK property market is estimated to be worth £5,480bn[1]. The residential market accounts for £4,670bn of the total, 65% of which is owner occupied. Commercial property represents around 12.5% (£683bn), with around 60% of this being 'investable'.

While the value of UK property overall is far greater than the London Stock Exchange and gilt market combined, commercial property on its own constitutes a smaller market than the other two asset classes – see Figure 2.

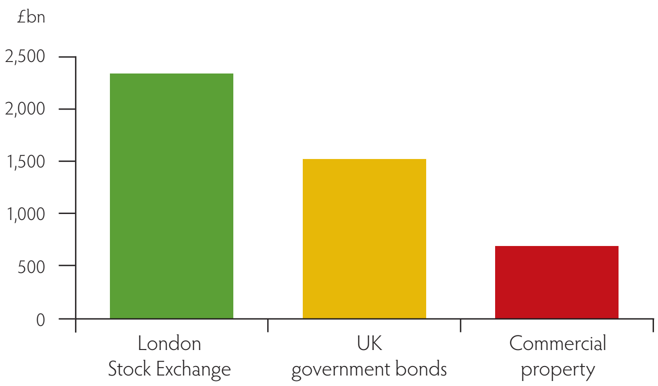
B. SECTORS

UK commercial property investment market value
£385bn (end-2013)

The UK property investment market has been dominated traditionally by three main sectors: Office (41%); Retail (39%); and Industrial (11%). Alternative property investments, e.g. hotels & other leisure and student housing, have increased their market share rapidly in the last few years.

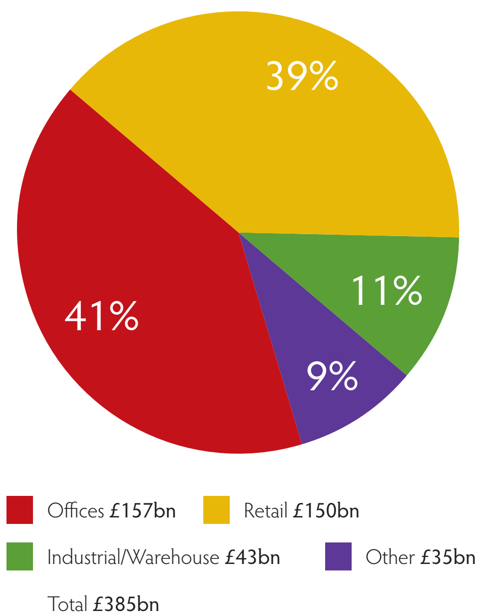
The main sectors have a mix of performance drivers that are both common (such as economic growth) and also sector dependent. Key performance drivers that are common across sectors include:

Figure 2: **Market value of UK equities, bonds and commercial property – End-2013**



Source: Property Data Report 2014

Figure 3: **UK commercial property investment universe, End-2013**



Source: 'The Size and Structure of the UK Property Market End-2013 Update', published by the IPF Research Programme, 2014

1 Data in this paragraph taken from *The Size and Structure of the UK Property Market End-2013 Update*, published by the IPF Research Programme, 2014

- Supply side: new development, refurbishment, planning restrictions.
- Demand side: location, economic growth & employment, population trends, infrastructure & accessibility, building aesthetics & design, obsolescence.

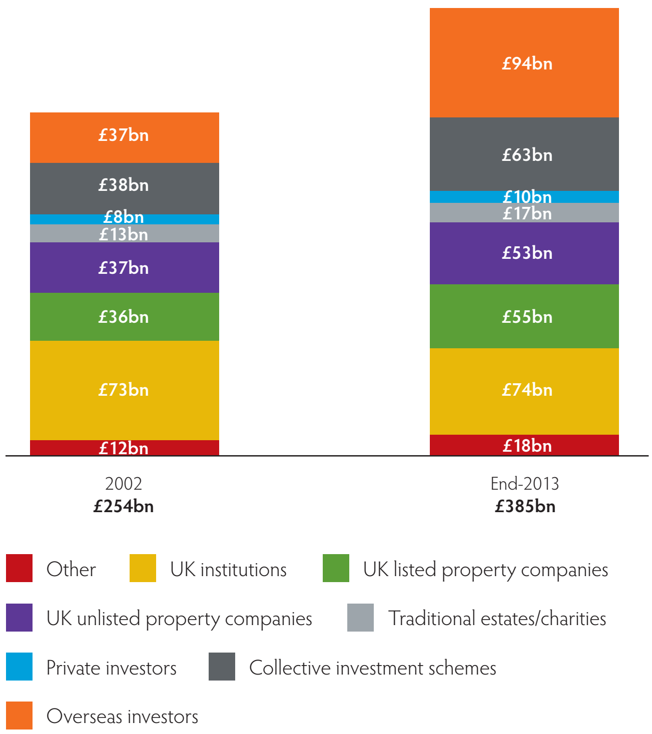
Details of sector specific factors are shown in Section 2.

3. Main participants in the investment market

The participants in the UK property investment market have changed significantly over the past 40 years. The traditional owners of property – the Crown, central and local governments, wealthy individuals and the Church – have been largely replaced by institutional investors, private equity funds, sovereign wealth funds, and other international investors.

There has been an increase in the number of overseas investors, with a particular focus on London, from a market traditionally dominated by domestic investors – see Figure 4.

Figure 4: **Breakdown by type of owner**



Source: *'The Size and Structure of the UK Property Market End-2013 Update'*, published by the IPF Research Programme, 2014

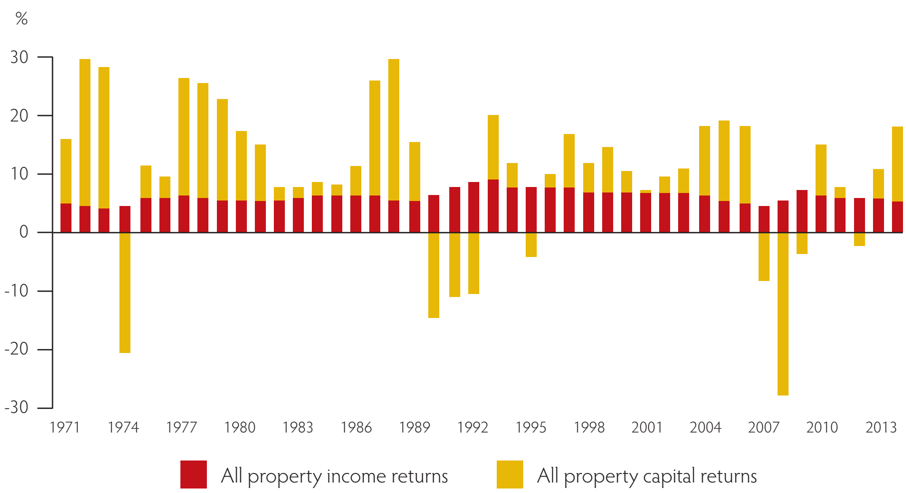
4. Property as an investment

A. RELATIVELY STABLE INCOME RETURN

Income (rent) from a property investment is produced as a result of a tenant's commitments under the terms of a lease. Rent is a first charge on the assets of a company and therefore takes priority over many other forms of debt. The underlying relative consistency of property rental returns, compared with capital returns, is shown in Figure 5.

Commercial lease contracts are also relatively long term in the UK, an average of seven years[2], and nearly all make provision for a review of the rent if the lease term is in excess of five years. Rents are usually reviewed to the level of the prevailing market at that time, supported by a provision

Figure 5: **Property: income and capital returns**



Source: IPD

2 Source: *UK Lease Events Review*, November 2014, prepared by IPD in association with Strutt & Parker and the British Property Federation.

that the change is based on upward only reviews.

In comparison with income from equities, property rent is generally much more predictable and certain. While conventional bonds (with the exception of those that are index-linked) also provide an assured return, they do not offer the prospect of income growth.

Figure 5 also underlines the cyclicality of capital returns from property and hence the importance of timing when deciding to buy or sell property.

B. INVESTMENT PERFORMANCE

The investment returns from investment property are usually compared with those from equities and bonds – see Figures 6 and 7.

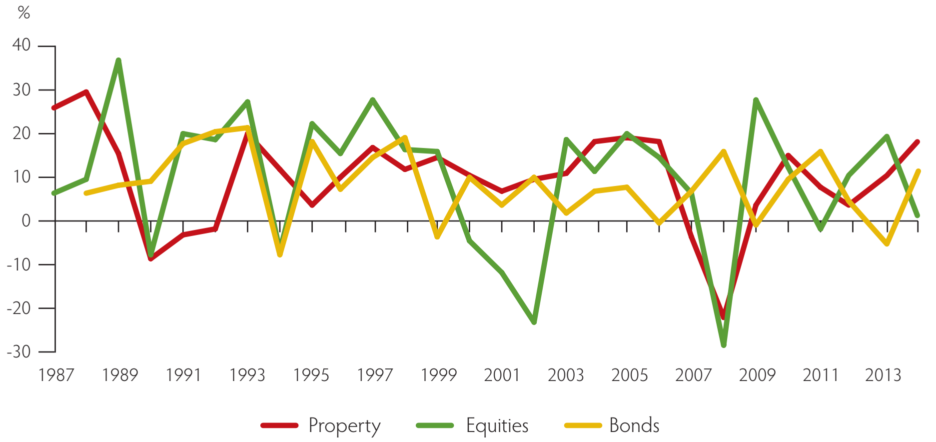
The short-term outperformance of property compared to the other asset classes can be a significant benefit to the investor prepared to manage their portfolio actively. Figure 7 above shows periods when property performed significantly better that equities and bonds.

In terms of risk, property is usually regarded as being between bonds (lower risk) and equities (higher risk) but with the benefit of potential income growth from rental uplifts. Figure 8 shows a comparison of the total returns from property, equities and bonds over the short, medium and long term. Commercial property's performance – at 10.8% per annum since 1971 (IPD's earliest data point) – sits between those of bonds and equities.

Figure 6: **Performance of commercial property compared with equities and bonds**

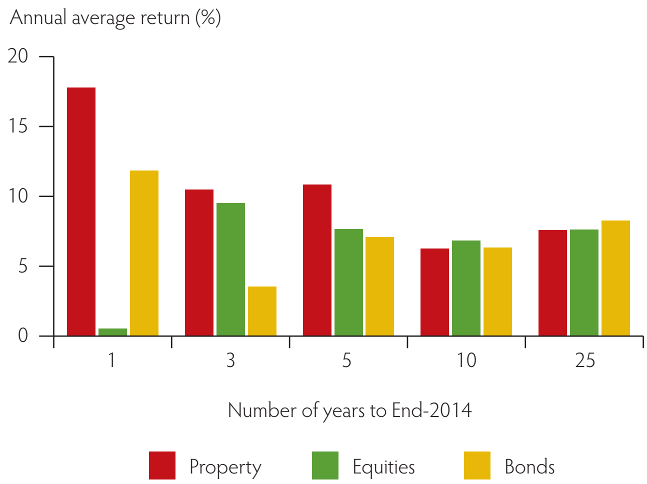
Sources: IPD, Bloomberg, Global Financial Data

Figure 7: **Total returns from equities, bonds and commercial property**



Source: IPD, Bloomberg, Global Financial Data

Figure 8: **Total returns from equities, bonds and commercial property over different periods**



Source: IPD, Bloomberg, Global Financial Data

C. VOLATILITY

Figure 7 shows that historically property returns have been achieved with lower volatility than those of the other two. One reason for including property as part of an investment portfolio is therefore to reduce overall volatility.

Part of this reduced volatility demonstrated by commercial property may be due to process of 'smoothing', whereby the valuation-based performance measurement of property tends to underestimate market peaks and troughs. However, smoothing is less of an issue now that valuations take place at much more frequently intervals (often monthly, or at least quarterly) than in the past when annual valuations were the norm.

It should also be note that the drivers behind asset allocation to property are now very different from 20 years ago, with more short-term, active investors (e.g. retail investors) being involved, and this has increased the volatility of cash flows to/from the sector.

D. LIQUIDITY

The process of selling and buying property takes a lot longer than trading equities or government bonds. This is because of the unique nature of every property, its complexity (both physically and from a legal perspective), the large unit size and the nature of the market in which transactions occur. Investing in direct property therefore involves a greater degree of liquidity risk than financial assets traded through centrally-traded exchanges.

Liquidity is also a consideration for investors in a fund holding direct property, although most funds accessible to retail investors have daily dealing. Generally, this is achieved by the fund holding higher cash levels to meet possible redemptions, which is likely to have an impact on the total returns achieved by the fund.

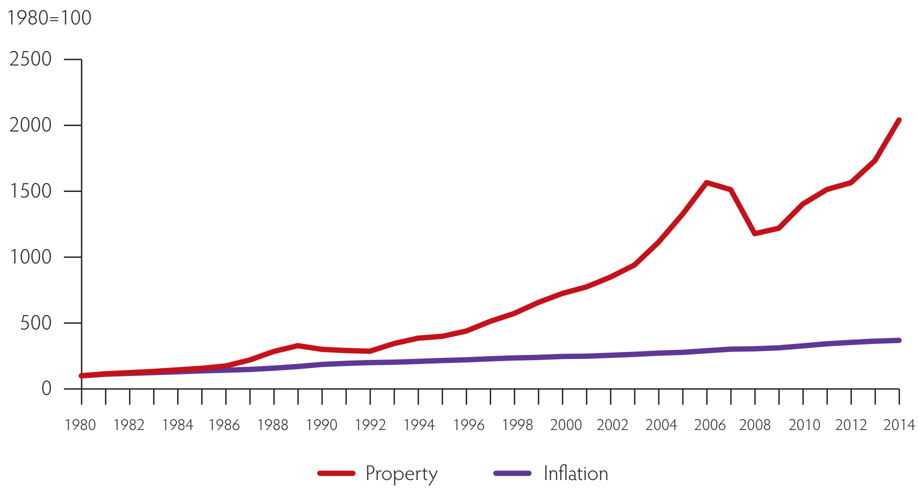
E. CORRELATION

Property has been seen as a natural diversifier due to its historic low correlation with other asset classes. This may be less clear cut in the wake of the Global Financial Crisis (GFC). The equity, bond and property markets are all subject to changes in the wider national and international economies but their impact on the pricing of the respective markets will differ in terms of timing and scale.

F. INFLATION

IPF research published in April 2011 found that property is not a hedge against inflation in most scenarios, where a 'hedge' is defined strictly as moving at the same time as inflation or reacting to it. However, property was found to deliver long-run real returns, as shown in Figure 9.

Figure 9: **Property total returns vs. inflation**



Sources: IPD, RPI

2: Drivers of property returns

Investment returns are created from both changes in asset value (capital return) and the cash flow generated from the underlying asset (income returns). The cash flows of a property depend on the lease structure and terms agreed between the owner and occupier or occupiers. Capital value is determined by the market but may be enhanced by active asset management.

The key drivers of property performance are outlined in this section.

1. Demand and supply

The rent at which a property will let or the price at which a property will sell is determined by the market. Strong demand from prospective tenants for particular buildings will lead to an increase in the rental value of that space, particularly if there is a physical restriction on supply, e.g. a shop in Bond Street in London's West End.

Figure 10: **Rent-free periods vs. market rents vs. yields**

Source: UK Prime Rents and Yields, CBRE; UK Lease Events Review November 2014, prepared by IPD in association with Strutt & Parker and the British Property Federation
Note: Rent free period is weighted by rent passing

The strong tenant demand also means that landlords do not have to offer tenants so much in the way of incentives to take the lease. This is illustrated by looking at rent-free periods at the start of the lease, a common incentive – see Figure 10. The graph shows that when rents are rising rapidly, the length of the rent-free periods being offered fell and the reverse was true when rental values were static or falling.

Capital values increase where there is higher investor demand (as well as high/improving tenant demand). For example, the value of trophy assets in the centre of London have grown more rapidly in value than property in the rest of the UK because of the high level of international investor demand.

2. Leases and asset management

A. RENT REVIEWS

UK commercial property leases generally provide for rents to be reviewed every five years and set to the market level where this is above or equal to the rent being paid at the time of the review. If the market rent is below the current rent, the rent would remain unchanged for the next five years. Although a 'five-year, upward-only rent review' is the most common review type in the UK, there are a number of other mainstream provisions:

- Fixed uplift rents: these are rents that are uplifted after a pre-established period (e.g. every three or five years) by a set value or percentage as stated in the original terms of the lease;
- Index-linked rents: these are rents that are linked to an index such as RPI inflation. Index-linked rents are common in Germany and they have increasingly been adopted by the UK investment market; and
- Turnover-related rents: these are rents that are set as a percentage of the tenant's business activity turnover from occupying the space. Turnover-related rents are less certain and more volatile than five-year, upward-only leases and are more difficult to value. These leases are most common in the retail sector.

Additionally, there has been an increase in hybrid leases, such as retail fixed-base rents with turnover-related top-ups.

B. LEASE LENGTH

Commercial property leases in the UK typically range between 5 and 15 years in length, with the market average currently being 7 years[3], compared with 23 years in 1990. Average lease lengths also differ across sectors, and sub-sectors, e.g. retail warehouse tenants generally want longer leases than those occupying standard unit shops. Location and the size of the space occupied also have a bearing on the length of the lease. With regards to the former, for example, tenants occupying offices in central London may want greater flexibility and therefore a shorter leases than office tenants in other UK towns/cities. As to the latter, tenants occupying large amounts of space are more likely to want a longer lease because of the level of upheaval associated with relocation.

Some leases include a 'break clause' that give the landlord and/or tenant the option to terminate the lease prior to its expiry date. This can impact the value of a property because the income stream is no longer certain for the full term of the lease.

C. COVENANT STRENGTH

The share prices of two manufacturing companies producing similar products may differ because of the market rating of each company.

Likewise, the capital value of two identical buildings occupied by tenants paying exactly the same rent will differ if there is a perceived difference in 'covenant strength' between the two tenants – investors would pay more for a building occupied by, say, Next Plc than a small private company, all other things being equal.

Covenant strength may affect investment value

3 Source: *UK Lease Events Review,* November 2014. Prepared by IPD in association with Strutt & Parker and the British Property Federation.

D. ASSET MANAGEMENT

In its simplest form, asset management is the collection of rent, the arrangement and recovery of insurance (if multi-occupied), the administration of contractual lease terms (e.g. rent reviews, lease renewals, repairing obligations), and the provision of services/maintenance to common parts (and the recovery of such costs, as may be applicable).

However, it may be possible to add value over and above that reflected in market pricing through active asset management. Investors seek to do this by measures such as 'right-sizing' tenants (providing them with the optimum sized unit), undertaking refurbishments and redevelopment, extending leases, or accessing rental reversions (i.e. where the rents received for space is less than the rental value of that space).

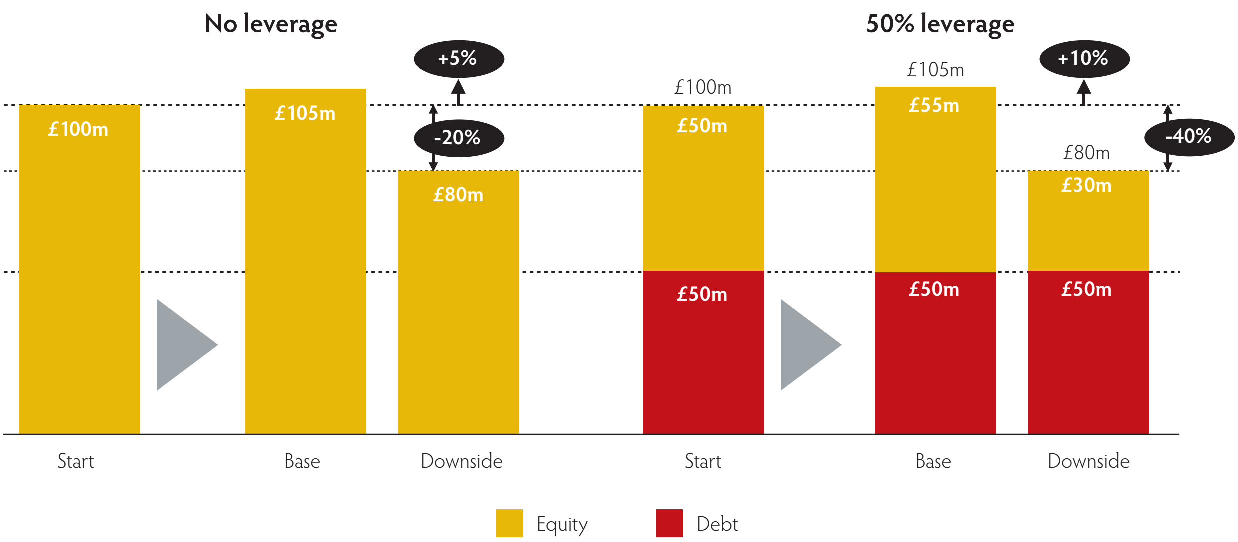
'Right-sizing' – the Bentalls Centre, Kingston is anchored by Bentalls department store, which previously occupied the majority of the site

3. Leverage

Leverage, or gearing, can be used to increase the return on equity during an upward or stable market. Conversely, leverage can exacerbate negative returns in a falling market. There is an increase in risk when using leverage to increase returns, as markets tend to move up gradually over long periods and suddenly and strongly down during crashes. The impact of leverage on returns in different market conditions is illustrated in Figure 11, which assumes a 5% increase and a 20% fall in capital value respectively on a notional investment of £100m. In the first instance, there is no leverage and in the second the investment is leveraged by 50%. For simplification, there are no interest or amortisation assumptions on the debt.

Before 2008, debt was readily available for commercial property transactions but during the GFC bank lending to commercial property fell significantly. Property markets are now recovering and vehicles exist to cater for all risk appetites: from traditional UK funds using no leverage through to opportunistic private equity funds borrowing as much as 80% against the value of the property.

Figure 11: **The effect of leverage on investments**



3: What are the risks?

Property has the ability to offer a range of risk and returns profiles, dependent on a particular investor's appetite. With regard to risks, some are common to other asset classes and others specific to property as an asset class. The principal types of risk are outlined below.

Principal risks

Asset level	Property market	Macro level
Stock specific risk One particular asset may be more vulnerable to particular market conditions than others. Stock specific risk is particularly important where one asset forms a substantial part of an investor's portfolio.	**Sector and Geographic specific risk** Holding a portfolio that is weighted to one sector or geography could mean that it performs better or worse than the property market as a whole at any moment in time. Holding a portfolio diversified by sector and geography helps reduce this risk.	**Economic outlook** The performance of the property market is closely correlated to changes in GDP: where the economy is growing, companies want to move to upgraded space and/or expand but in downturns, companies seek to cut outgoings, including property costs.
Tenant A thorough assessment must be made of any tenant's ability to meet their rental obligation to a landlord. A tenant with a strong financial covenant can increase the value of a property as the future income is deemed to be more certain. There is also the risk that tenants may not renew their leases or they may choose to exercise a 'break' clause which allows them to exit their lease on a particular date before it has run its full term. In a weak occupier market, a shorter lease may impact on the value of the property.	**Finance** The availability and cost of debt in the property market can vary substantially. After the GFC many banks withdrew from lending to the market and the margins on the debt that was available increased, despite the fact that interest rates remained unchanged. **New loans to commercial property 2014** £45.2bn[4] (De Montfort University)	**Regulation** Changes in legislation and regulation that impact the property market may make property a more or less attractive proposition for investors. Regulation with regard to the environmental credentials of properties is very much in the news. This is intended to achieve the admirable aim of reducing energy consumption but to meet the required standards may mean additional costs to the investor.
Valuation Valuations are required to act in place of 'exchange prices'. The role of a valuer is to estimate what a property would transact for if it were to be traded between two willing parties at that moment in time however, this is not a guaranteed sale price.	**Investor confidence** Property values, as with any market, are impacted by investors' confidence in the asset type. This sentiment can quickly shift in either direction and feed through to prices and valuations.	**Currency** As with any investment that is made outside of an investors domestic currency an exposure to currency fluctuations will be created. In such a case, investors may wish to consider the use of derivatives for currency hedging.
Environmental risk Changes in the surrounding environment, such as flooding risk or land contamination, could create risks to the fabric of the building.	**Development** Developments are generally more risky than standing investments. When combined with leverage, developments are very risky and fare disproportionately well in booms and poorly in downturns. *© iStock.com/bsak*	**Interest rate changes** Interest rates affect the cost of borrowing for the property market. They also impact the pricing of government bonds and equities, which in turn changes the relative attractiveness of property.
Liquidity Property is an illiquid asset, both in terms of time to transact and price transparency, relative to equities and government bonds.		**Taxation** Changes in taxation can affect the value of property and its relative attractiveness as an investment compared with other asset classes, e.g. stamp duty (now SDLT) was increased on commercial property over £500,000 from 1% to 4% between 1997 and 2000.

4 Source: *The Commercial Property Lending Market 2014,* published by De Montfort University in 2015.

4: Routes to property investment

Investors can buy property investments directly and hold them outside of any collective/diversified structure. That is the 'purest' way of accessing property returns, but bears significant specific risks for investors (depending on how much capital they have to allocate, and therefore what level of asset diversification they can create), as well as the cost of transacting and holding these assets.

If direct investment is not appropriate for whatever reason, investors looking at structures through which to invest (e.g. a collective fund or a listed property company) need to be aware of the factors that impact their returns at a unit/share level.

Outlined below are a number of issues that investors may wish to consider before investing in property.

General considerations

INVESTOR'S TIME HORIZON AND LIQUIDITY REQUIREMENTS As outlined in Section 2, direct property can take many weeks to sell – the time being dependent on the type and quality of the asset, coupled with the state of the property market at the time. Some collective property funds have daily pricing, while at the other extreme funds my have very limited opportunities to redeem.	**Short term** Consider: • Real estate investment trusts (REITs) and other listed property companies • Collective property funds that allow for liquidity at short notice	**Medium/long term** Consider: • REITs and other listed property companies • Collective property funds • Direct property • Life bonds operated by insurance companies • Self-invested personal pension (SIPP)
INVESTMENT IN SPECIFIC SECTORS/LOCATIONS As explained in Section 1, the drivers for growth for different sectors and locations within the UK property market can differ. Investors wishing to take advantage of a sector/location offering potentially higher returns than the 'All Property' average can do so by investing in either direct property or indirectly through some REITs/listed property companies or collective investment funds. Investment by sector and/or location generally produces greater volatility in total returns than for a balanced portfolio.	**Direct property** Some investors have specialist expertise in particular property sectors and/or locations and are therefore able to achieve higher returns than the 'All Property' Benchmark. The level of investment risk associated with this strategy can be affected by holdings in other asset classes, e.g. arguably there is lower asset correlation from investing in industrial property and retailer equities than in investing in the retail sector for both asset classes.	**Indirect investment** Some REITs/listed property companies and funds only invest in certain sectors/subsectors of the property market, e.g. shopping centres, student housing etc. Others are focused on specific geographies, e.g. central London. NOTE: Sector and regionally focused funds do not tend to be available to retail investors.

Sector performance drivers

Retail
- Catchment
- Competition
- Retail mix
- Impact of ecommerce

Industrial
- Distribution network
- Proximity to customers
- Access to skilled labour

Offices
- Business demand
- Workforce availability
- New supply

Alternatives
- Asset and tenant dependant

PROPERTY PERFORMANCE MEASUREMENT	**Direct property**	**Indirect investment**
	The principal benchmarking organisation for the direct property investment industry is the Investment Property Databank (IPD) – now part of MSCI. IPD provides monthly, quarterly and annual indices for the UK and other established commercial property markets.	The listed property market tends to use the FTSE/NAREIT indices. For indirect (funds), there is the AREF IPD UK Quarterly Property Fund Index. The Index includes balanced funds (with property across all the main sectors) and sector-focused funds.
INVEST IN DIRECT PROPERTY?	**Pros**	**Cons**
Investors can buy property investments directly and hold them outside of any collective/diversified structure. That is the 'purest' way of accessing property returns, but it bears significant specific risks for investors (depending on how much capital they have to allocate, and therefore what level of asset diversification they can create).	• Ownership of physical asset(s) • Achieve direct property returns • Have control over property investment decisions • No fund management costs	• Large investment required per property • Limited diversification unless sizable portfolio of properties • Reliance on own expertise or paid-for advisers • Property management time and expense • Relative lack of liquidity

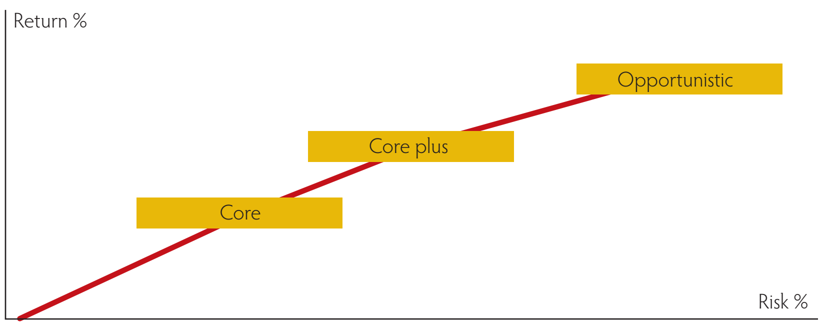
Investing indirectly

Once investors start looking at structures to invest in, with those structures themselves holding the assets (e.g. a collective fund or a REIT/listed property company) other factors will impact the exact nature of their returns at a unit/share level.

These factors include: vehicle management costs, tax leakage, the bid/offer spread or movement in pricing basis, the impact of any leverage/borrowing within the vehicle, the liquidity requirements of that vehicle (and therefore the non-direct property assets or cash it might hold), secondary market pricing of units/shares (i.e. whether they are trading at a premium or discount to the net asset value of the underlying assets), and whether the vehicle's price is a reflection of the net asset value of actual assets or the value of derivative contracts/synthetic investments.

INVESTMENT VEHICLE STRATEGY	Investment risk: lower		higher
Broadly funds/investment vehicles will employ three styles of investment strategy, depending on their approach to investment risk. This is shown in graphic form in Figure 12, below.	**Core** Tend to: • Be unleveraged • Comprise higher quality (and relatively liquid) assets with reasonable income duration and security • Offer limited asset management opportunities.	**Core plus (also known as value-add)** Tend to: • Employ some leverage • Focus on properties with more risk but with greater opportunity to add value.	**Opportunistic** Tend to: • Be leveraged • Focus on less liquid assets with a higher risk/return reward profile, for example, largely or completely empty buildings, development sites, buildings with only a short time remaining on the leases and 'over-rented' buildings

Figure 12: **Risk/return profiles of funds**



LIQUIDITY OFFERED BY LISTED OR UNLISTED VEHICLE?

Investors buying property investment exposure through a vehicle have the choice of listed and unlisted vehicles.

The liquidity profile of these options varies between listed and unlisted and unlisted open-ended and closed-ended funds.

Listed

Listed vehicles have secondary liquidity in their shares so investors can acquire/dispose of their holdings on exchange with a degree of price certainty and confidence over how long that will take.

However, the downside of this is that the performance of the vehicle (i.e. the market value of the shares) can be more influenced by movements in equity markets generally (particularly over shorter periods) than the valuation movements of the underlying assets.

Unlisted

Unlisted vehicles can be either companies or trusts, open-ended or closed-ended and geared or un-geared.

Liquidity is dependent on the requirements embedded within each fund. Those offering daily pricing are likely to hold significant amounts of cash or liquid securities, which will dilute/alter the effect of the direct property portfolio performance on the vehicle-level performance.

Some unlisted vehicles are completely closed-ended. Liquidity in their units is therefore entirely dependent on the depth of the secondary market, and unlike listed funds/vehicles there is no obligation on them providing a minimum free-float.

WHAT DO FUNDS CHARGE AND HOW ARE THEY PRICED?

Annual management charges vary from fund-to-fund and between different fund types.

Fund pricing: An incoming investor pays the offer price and an outgoing investor receives the bid price. Setting these prices is done generally under a single swinging pricing model.

Charges

Fees can be charged to income or capital (and in some cases both), so investors should be aware whether the net yield they are receiving is being enhanced at the cost of the fund's net asset value.

This may also have an impact on the tax paid by the fund.

Pricing

The majority of (certainly authorised) funds in the UK currently adopt a single swinging pricing model. This is to reflect flows into or out of the fund, and ensure that all investors bear an equal proportion. In other words, if a fund is seeing net outflows, and is holding 10% of its assets in cash (and 90% in direct property) then it will be priced at 'bid' or 'cancellation', which will be the net asset value of the fund less 90% of the cost of selling direct property and 10% of the cost of selling cash. If the same fund is seeing net inflows, then it will be priced at 'offer' or 'creation', which will reflect the cost of investing 90% in direct property and 10% in cash. Since the purchase/sale costs of direct property (SDLT, fees etc.) are relatively high, this can lead to a spread between bid and offer of around 5.0%-5.5%.

OTHER INDIRECT ROUTES

Three other mainstream routes to gaining indirect exposure to the UK commercial property market, in varying degrees, are outlined here.

Secondary market

The UK now has an active market (approximately £1.5bn per annum) for the sale of interests in open and closed ended funds. Investors can buy positions in existing funds. In closed-ended funds this provides liquidity that would not otherwise exist. In open-ended funds, secondary transactions avoid the bid/offer spread on subscriptions and redemptions.

Debt funds

Recently, there has been an increase in the availability of funds providing senior or mezzanine debt against direct property investments. The majority of these funds are only open to institutional investors, and are provided by life assurance companies (both from the UK and from Continental Europe) for whom recent changes in regulations have encouraged them into low risk, asset-backed lending.

Property futures

Property futures are another way to buy and sell commercial property exposure. An investor in property futures gets exposure to physical property via a property index (generally based on the IPD quarterly index, which is more diverse than any REIT or unlisted fund. Property futures are transacted on a regulated financial exchange, Eurex, and attract a range of investors from large institutions to private individuals.

Investment routes for retail investors

CHOICE OF INDIRECT ROUTE

Investment considerations
- Listed or unlisted
- Open-ended or closed-ended
- Transparency
- Investment strategy
- Amount of investor control
- Investment performance
- Specialist sectors/locations
- Regulation/jurisdiction
- Fund tax status
- Tax on distributions
- Costs of management
- Level of gearing

Investor requirements
- Level of retail investor sophistication
- Target returns
- Need for liquidity
- Amount to invest
- UK taxpayer/non-taxpayer
- Level of control required

INVEST?

YES ↓

NO → Invest elsewhere

LISTED OR UNLISTED INVESTMENT?

Listed

Traded on exchange like other UK FTSE equities and subject to the listing rules of the London Stock Exchange (LSE).

- REITs are exempt from corporation tax on their property rental business but subject to distribution requirements.
- Other quoted property companies pay corporation tax but are less constrained by distribution requirements.

Unlisted
- UK authorised funds structured as unit trusts (where investors hold units in a trust) or open-ended investment companies (OEIC), where investors hold shares in a company.
- Non-UK funds, e.g. Guernsey property investment companies, Jersey property unit trusts (JPUT)
- Life bonds
- Pension schemes
- Limited partnerships

UNLISTED?

YES ↓

NO → Invest through listed vehicles

INVESTMENT PERIOD?

Shorter term
- UK fund structures
  - Authorised property unit trusts (APUT)
  - OEIC/property authorised investment funds (PAIF)
- Non-UK funds, e.g. Guernsey property investment companies, Jersey property unit trusts (JPUT)

Medium/Longer term
- Unit-linked life bonds – operated by insurance companies
- Pension schemes and self-invested personal pensions (SIPPs)
- Limited partnerships

5: Indirect investment: Legal and tax overview

The table below provides a legal and tax overview of the principal means of investing indirectly in UK commercial property.

	Real estate investment trust (REIT)	Authorised property funds (OEIC and APUT)	Property authorised investment fund (PAIF)	Limited partnership (LP)	Unit-linked life bond	Self-invested personal pension (SIPP)
Legal form	PLC Must be listed and closed-ended.	Open-ended investment company (OEIC) or authorised property unit trust (APUT) Regulated and open-ended.	OEIC Regulated and open-ended.	Typically contractual arrangement and closed-ended.	Operated by UK life companies as life insurance policy.	Scheme for individuals to self-invest for their personal pension.
Fund tax Status	Exemption for property rental business income and gains.	Subject to corporation tax (CT) on rental income at a rate of 20% but exemption for capital gains (non-trading).	Exemption for property investment business income (i.e. rents, REIT dividends). Subject to CT otherwise but typically little or no tax.	Tax levied on partners directly (tax transparent).	Subject to CT under specific rules.	Income and gains on investments held in SIPP are exempt from tax.
Withholding tax on distributions	Distributions from property investment business are subject to 20% withholding tax but typically paid gross to e.g. UK corporates, ISAs, pensions.	No withholding tax on distributions.	Distributions from property investment business are subject to 20% withholding tax but typically paid gross to e.g. UK corporates, ISAs, pensions.	No withholding tax on distribution (non-residents may need to register under the Non-Resident Landlord Scheme to avoid deduction of income tax of 20% on rents).	Bondholders can generally withdraw 5% of their initial investment annually without an immediate tax charge (deferred).	No withholding tax on withdrawals.
Taxation of individual investors	Distributions from property rental business are taxed as UK property income (with credit for tax suffered on distribution). Any other distributions are taxed as dividends (with 10% notional credit).	Distributions are taxed as dividends (with 10% notional credit).	Distributions from property investment business are taxed as UK property income (with credit for tax suffered on distribution). Any other distributions are taxed as dividends (with 10% notional credit) and/or interest.	Partnership profit allocations are taxed and in accordance with the nature of the underlying profits, (e.g. UK property income in respect of partnership rental income) at partners' individual tax rates.	Intermediate withdrawals are considered when calculating the gain on ultimate surrender of the policy (no extra tax should be due unless higher rate taxpayer).	From 6 April 2015, those aged 55 or over can access their SIPPs flexibly, via drawdown or lump sums without having to purchase annuities. To the extent that the total lump sum falls within the available lifetime allowance, 25% will be tax free and 75% charged at marginal rate income tax.

	Real estate investment trust (REIT)	Authorised property funds (OEIC and APUT)	Property authorised investment fund (PAIF)	Limited partnership (LP)	Unit-linked life bond	Self-invested personal pension (SIPP)
Tax suffered by higher rate (HR) and additional rate (AR) taxpayers for the 2015-16 tax year	Property income distribution tax at 40% (HR) and 45% (AR). Gains on disposal taxed at 28% (HR and AR).	Dividend income taxed at 32.5% (HR) and 37.5% (AR).	Property income distribution tax at 40% (HR) and 45% (AR). Gains on disposal taxed at 28% (HR and AR).	Taxable partnership property income taxed at 40% (HR) and 45% (AR). Gains on exit/sale of partnership property taxed at 28% (HR and AR).	HR and AR taxpayers are subject to tax on gains.	Income from annuity is taxed at 40% (HR) and 45% (AR). Contributions can benefit from basic rate income tax relief; HR/AR taxpayers can claim back additional tax relief through their returns.
Activity limitations	Relevant criteria include e.g. 1) 75% of assets and income from property 2) penalties if corporate investors holds >10% 3) distribution of 90% of tax-exempt rental profits.	Distribution of 100% of post-tax income profits.	Relevant criteria include 1) 60% of assets and income from property 2) 10% ownership restriction for corporate investors. 3) distribution of 100% of post-tax income profits.	No specific conditions in tax rules. Most seek to avoid trading treatment. Scottish LPs – unlike LPs registered in England & Wales (ELPs) – enjoy separate legal personality and can hold property investments in their own names. An ELP typically holds property investments via a trust structure, e.g. two nominees.	Subject to tax rules for UK life companies.	SIPPs typically commit through an exempt unauthorised unit trust.
Transfer taxes[5] *(References to stamp duty land tax (SDLT) include land and buildings transaction tax (LBTT) in Scotland. For further details see figure 13 below.)*	The transfer of shares is subject to either stamp duty (SD) or stamp duty reserve tax (SDRT) at 0.5% if UK company.	SDRT abolished from 1 April 2014.	'SDRT abolished from 1 April 2014.	On disposal, SDLT may be payable; potential for SDLT on entry.	SD when the bond is surrendered or issued for cash but can arise in other cases.	Not applicable for contributions into SIPPs, but investment transactions within scheme may be subject to SD or SDLT.

Tax on UK commercial property transactions

Stamp duty land tax (SDLT)[6]		Land and buildings transaction tax (LBTT)[7]	
Purchase price	**Rate**	**Purchase price**	**Rate**
Up to £150,000	0.0%	Up to £150,000	0.0%
Over £150,000 to £250,000	1.0%	Over £150,000 to £350,000	3.0%
Over £250,000 to £500,000	3.0%	Over £350,000	4.5%
Over £500,000	4.0%		

5 Source: *The Commercial Property Lending Market 2014,* published by De Montfort University in 2015.

6 Applies to all parts of the UK except Scotland. Percentage payable on full amount. SDLT on residential transfers are subject to a different method of calculation and tax rates.

7 Applies in Scotland. Percentages relate to the respective 'slice' of the transaction price. The same basis of calculation and rates apply to residential transactions.

Appendix A: Regulatory context

A. FINANCIAL SERVICES AND MARKETS ACT 2000

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 were held in a 'collective investment scheme' (CIS), then those holdings do come under the FSMA regime. Property investment vehicles – which do not comprise companies – are generally CISs and under FSMA, they are either 'regulated' or 'unregulated'.

Regulated CISs – which include PAIFs and APUTs – may be marketed to the general public. Unregulated CISs – such as LPs – cannot be marketed to the public (retail investors), only particular qualifying investors. These include:

- Market counterparties: for example, a government, central bank and a FCA authorised firm;
- Professional investors: for example, a local or public authority, high-net-worth company or a high-net-worth partnership or trust and unregulated CIS; and
- Investment professionals, certified sophisticated investors and certified high-net-worth individuals.

FSMA requires FCA authorised firms that promote an unregulated CIS to comply with various requirements in relation to these qualifying investors and to take reasonable steps to communicate with an investor in a way that is 'clear, fair and not misleading'. In addition, there are restrictions relating to the promotion of an unregulated CIS – which also apply to similar investment products that the FCA considers high risk and complex – and classified as 'non-mainstream pooled investments'.

B. ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

In addition, the Alternative Investment Fund Managers Directive (AIFMD), which is intended to provide additional protection for investors, took effect from 22 July 2013.

AIFMD applies to managers of real estate and other alternative investment funds with responsibilities for portfolio and/or risk management and who operate within the scope of AIFMD: for instance, with their assets under management with gearing in excess of €100m. The managers are required to be authorised under AIFMD and meet capital adequacy requirements, and – in relation to their funds – engage a depository (to protect investors' interests) and satisfy transparency, risk management delegation, remuneration and other compliance requirements.

Appendix B: Valuation of commercial property and pricing of indirect investments

1. Valuation of commercial property

Unlike other financial assets, direct commercial property does not trade on an exchange with openly quoted prices. Therefore, valuers are required to estimate the value of an asset, using financial information about the property combined with market data.

The Royal Institution of Chartered Surveyors (RICS) Appraisal and Valuation Standards (known as 'The Red Book') is the national valuation practice standards in the UK. They are used by RICS members (chartered surveyors), who value most of the investment property in the UK.

Properties are valued principally for performance benchmarking, financing or transaction purposes:

- Performance benchmarking: investors typically benchmark performance for reporting, analysis and shareholder information purposes. Performance is measured using income and capital returns. The major index provider used for benchmarking in the UK property market is the Investment Property Databank (IPD). As at end-2014, the index universe consists of 22,985 properties with a total value of £183.7bn and is measured annually, on an ungeared basis;
- Financing: assets are valued for borrowing or capital raising purposes; and
- Transactions: investors may instruct their valuers to deviate from the RICS standards by using a net present value (NPV) or internal rate of return (IRR) approach, with a bespoke set of assumptions, that are appropriate for the investor to make buy/sell decisions.

The methods used depend on the asset being valued and the purpose of the valuation, as illustrated in the table below.

Commonly used methods for valuing property

	Investment method	Comparison method	Residual method
Explanation	Discounted cash flow (DCF) analysis, either using a net present value (NPV) or internal rate of return (IRR) method.	Valued based on a comparable basis, adjusted for a range of factors such as the size and/or the age of the building. Using transactional evidence collated with qualitative judgement to adjust for the property specific features.	Estimated total value of the project, less all costs required to complete, adjusting for required profit on investment.
Typical use	Retail, Office, Industrial	Residential	Development appraisals

These methods are used by both valuers and investors, though the inputs may differ significantly. Valuers aim to determine the 'open market value' of an asset using inputs that best describe the views of the market as a whole, whereas investors will change the inputs, based on their personal predictions on the future performance of the asset.

2. Pricing indirect investments

The pricing of indirect interests in commercial property depends on the channel through which the investment has been made, as outlined below.

A. PRICING LISTED PROPERTY COMPANIES/REITS

Listed property companies and real estate investment trusts (REITs) are quoted on the London Stock Exchange and therefore the price of their shares is determined by the market. As with the listed funds (see below), this means that the share price can reflect a discount/premia to net asset value (NAV).

NOTE: There are currently four REITs in the FTSE 100 (The British Land Company, Hammerson, INTU properties and Land Securities).

B. PRICING LISTED AND UNLISTED FUNDS

The pricing basis for units in unlisted funds depends on whether they are 'closed-ended' (i.e. traded only on the secondary market between investors) or 'open-ended' (i.e. traded with the fund manager/operator).

OPEN-ENDED FUNDS

These are generally priced on a basis which refers to their underlying NAV. Essentially this is the value of the assets, adjusted in accordance with current accounting standards (e.g. UK GAAP or IFRS). In addition, there is normally an adjustment to reflect the costs of buying/selling the assets, so that incoming or outgoing investors are bearing the costs equally. Some funds include a 'dilution levy', which allows them to charge greater costs (or give a lower than NAV-adjusted price) to outgoing investors at times of significant market stress. This practise is not permissible for authorised funds, regulated under the COLL Sourcebook of the Financial Services & Markets Act. However, such bid/offer and cancellation/creation pricing can be complex, and may vary from fund to fund. It is therefore essential that investors investigate fully the basis upon which their fund price is derived.

CLOSED-ENDED AND LISTED FUNDS

These funds tend to be priced primarily on a 'market capitalisation' basis. This means that they may be trading at material discounts/premia to net asset value, due to investor sentiment on future growth/performance. As a result, the pricing of units/shares in such funds, tends to be more volatile than that for open-ended funds where the asset value driving the net asset value is calculated on a less frequent basis.

NON-UK UNLISTED FUNDS

It is worth mentioning that not all funds investable to UK-domiciled investors only invest in UK assets. Many funds invest in wider pools of assets in other countries as well as the UK, and some funds focus solely on investing outside of the UK. For these funds, the extra considerations of currency volatility (if no currency hedges are in place within the fund) and differential tax treatments can lead to pricing and performance differentiating significantly from the performance of the underlying assets.

Investment Property Forum

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About the IPF

The IPF is one of the leading specialist property industry bodies in the UK. It comprises an influential network of senior professionals, all active in the commercial property investment market.

The IPF's mission is to enhance the understanding and efficiency of property as an investment, including public, private, debt, equity and synthetic exposure, for its members and other interested parties, including government, by:

- undertaking research and special projects and ensuring effective communication of this work;
- providing education; and
- providing a forum for fellowship, discussion and debate amongst our members and the wider investment community.

For further information about the IPF and its research/publications, contact Sue Forster, Chief Executive, email: sforster@ipf.org.uk, tel: 020 7194 7922 or visit www.ipf.org.uk

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The Association of Real Estate Funds (AREF)
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European Public Real Estate Association (EPRA)
www.epra.com

Investment Property Databank (IPD), part of MSCI
www.msci.com/real-estate

The Personal Finance Society (PFS)
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