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Investing in Commercial Property

Successful Strategies
for the Private
Investor

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Editor

LandlordZONE™



Investment - not Speculation!

“An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative”

Benjamin Graham THE INTELLIGENT
INVESTOR

Investment Alternatives

- Cash
- Stock Market (7% over 10 years – IPD)
- Pensions
- Buy-to-Let – Residential
- Commercial Property
 - Average returns (11.5% - 10 yrs - IPD) **best performing asset** class over one, three, five, ten and possibly even 15 years!

The Market

- Interest Rates
- Inflation
- Employment – Retail & Residential
- Consumer spending and debt - Retail
- Economic performance – local areas
- GDP – most important for Industrial
- The future ?

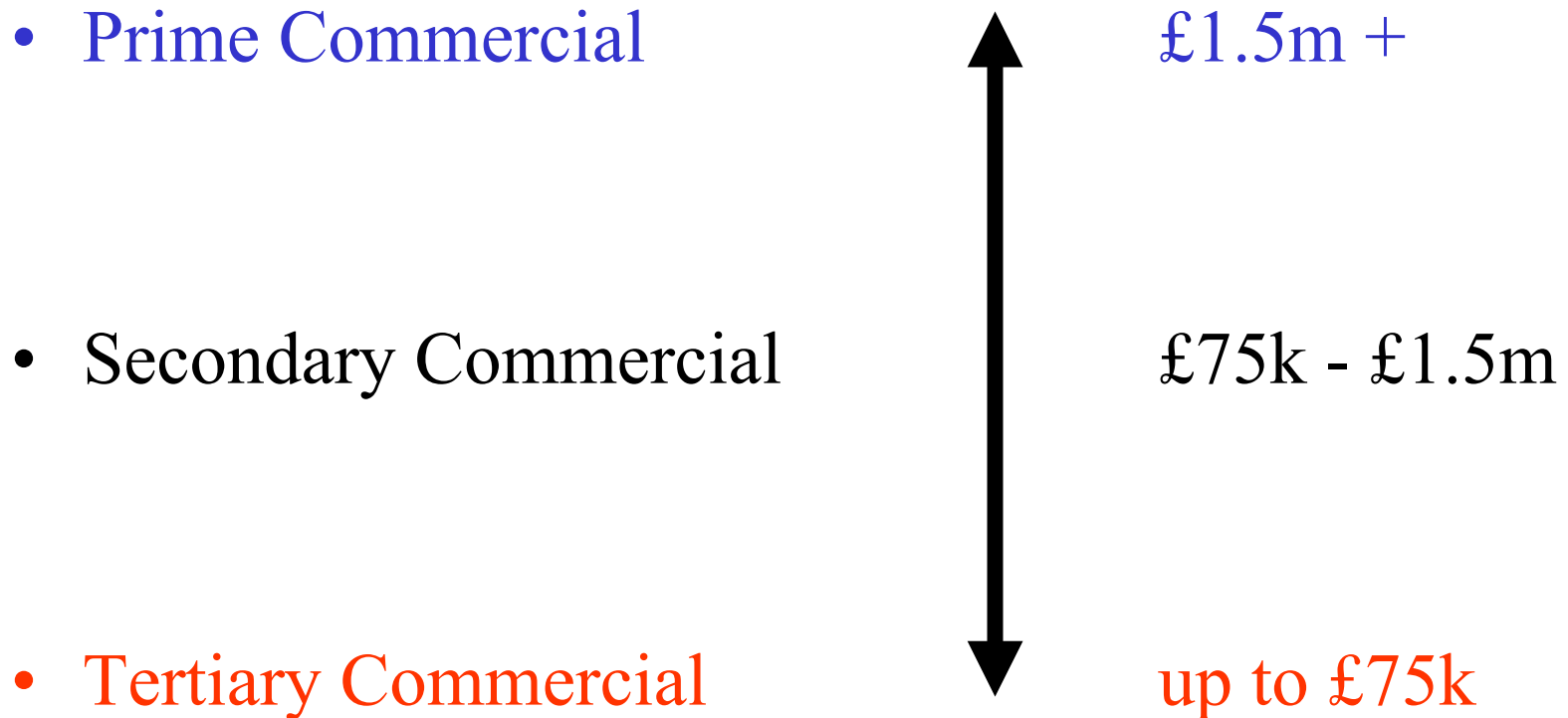
Residential

- Spectacular returns over last 10 years
- Combined income and capital growth has been possible well over 16% returns – possible to borrow big!
- This growth unlikely to continue over next 5 years
- Competitive letting environment – discerning tenants
- Refurbs and facelifts
- Tougher landlord rules and regulation on the way
- Sustainable values – demand for housing continues
- Planning restrictions and environmental issues help

Commercial Property ?

- Out-performed stock market over 10 years
- But not easy for the average investor to find a way in (and out!):
 - Retail Shops
 - Offices
 - Industrial - Workshops / Units / Storage
 - Leisure
 - Mixed use – shops/offices/residential

Spectrum of Quality / Value



Preserve of the Professionals?

- Traditionally:
 - Institutional Investors
 - Property Professionals
- Now – encourage the “amateur” ?

“It is in the interests of the entire property market to keep private investors as long-term investors in the market”

- Richard Auterac, EG August 2002, Director & Auctioneer, Jones Lang LaSalle

Ways in !

- Property company shares
- REITs / PIFs – coming ?
- Property Investment Trusts
- Clubs and syndicates
- SIPPs
- Straight investments – let to blue chips (top FSTE 250) or small businesses
- Investing to develop and convert.



Auctions

- **Investor demand** is currently high, not always supported by **occupier demand**
- Properties commonly meeting and **exceeding top guide** prices at auction
- Increased interest from **equity investors** disillusioned by the stock market – have money but not traditionally property investors
- **Entry level** – arranging **finance often difficult** given tight timescales

What are the Prospects?

- Global **recovery uncertain** - prospects for UK property appear **positive long-term**.
- **Retail** remains strong and tends to be steady, but:
 - Out of town trends and changing town centres
- **Office** demand has faltered in many locations:
 - 9/11 effect, increasing use of technology, more home working, more off-shoring
- **Industrial** is more volatile in terms of supply and demand and therefore more risk

Risk / Reward / Effort - Spectrum

- 20 % + secondary /development / conversions
- 11% - 19% - secondary / convert
- 7-10% prime to good secondary
- 4.5% - Building Society



Example Conversion

- Parade of shops
- Newcastle
- Apartments – 2 bed
- £150,000 each
- (stand 107 - Premier)
- Shops let – income £35k
- Investor to retain commercial



Retail Shop / Offices

- Halifax, Yorks
- Calderdale Council
- Sale £156,000
- Guide (£110 – 130k)
- 4 tenants (1-5 year)
£14,400 pa
- Yield 9.2%
- Pugh & Co, June 2004



Retail / Residential

- Manchester
- Sale £220,000
- Rental Income £35,625
- Various leases incl. Boots Chemists
- Yielding 16.2%
- Auction, July 2002 by Pugh & Co



Retail - Restaurant

- East Lancs Rd, St Helens
- Rental £35,000 (u review c50k?)
- Sale £500,000 Freehold
- Guide (450-500k)
- 30 yr FRI lease to Forte (UK) from 1999 (br 2014)
- Yield 7%
- Pugh & Co, June 2004



Industrial Unit

- Sandycroft, Deeside
- Rental £24,000
- Sale £257,000
freehold
- Guide (£200-240k)
- PLC – 5 year FRI
from Oct 2002
- Yield 9.34%
- Pugh & Co, June 2004



Retail Shop / Offices

- Windsor, Berkshire
- Sale £1m freehold
- Guide (£975k-£1m)
- Basement, ground and 3 upper floors – 3 shop frontages.
- Total Rents £77,500 reviews 2005
- Yield 7.75%
- Allsop & Co, July 2004



Pros - ComProp 1

- Relatively **High Income**
- **Steady growth in value** if unspectacular
- Established UK property **market structure**
- Institutional Lease principles – **clear return**
- Tenants accept **FRI lease** - protects landlord rights
- **Established disciplines** for valuation, finance, service charges, rent reviews, lease renewals etc.
- The property market has **SOME liquidity**.

Pros - ComProp 2

- Upward only **rent reviews** – 3 to 5 years*
- **Long leases** compared to residential
- Commercial generally requires less initial **refurbishment** cost
- Often **minimal management** involvement
- Managing agent – not necessary?

* Under review

SIPP – Self Administered Personal Pension

- Rental income is paid untaxed into the SIPP
- Up to 75% mortgage is allowed to purchase
- All legal costs and disbursements paid from the fund
- No Capital Gains Tax payable on sale of property
- Reclaim VAT on property improvements
- Pensions may be payable from rental income
- No limit on the number of properties which can be purchased
- Fund can buy property from own business and continue to use it, with a minimal impact on the business's liquidity
- You can purchase a share of a property

Cons: ComProp

- Higher commercial **lending rates**.
- Higher **average lot values** – more difficult to spread risk – but syndicated investments?
- Less spectacular rises in **capital values**, compared to residential
- Values can go down in **declining areas** or where occupancy rates decline

Finance - Commercial

- More difficult to raise finance
- Every deal is different – no packages like buy-to-let
- Different lenders have different policies so you need to shop around
- Rates vary - 1% to 5% above base for £500K to £1m
- Experienced brokers
 - Mathew Farrow – **The Money Centre**
 - Steve Bedford – **Mortgages for Business**
- Buy-to-let – borrow up to 85% LTV
- Commercial – borrow up to 60 / 70% LTV

More on Finance

- Lenders carry out thorough **due diligence**:
 - **Quality of property**, land, development or conversion
 - **Quality of the tenant** or prospective tenants – blue chip (Top FTSE 25) with long lease offer greatest **covenant strength**.
 - **Quality of Applicant** – “a **track record** is worth its weight in gold”
 - **Quality of builders**, use of architects and professionals

Development & Conversations

- More **work**, more **risk**, greater **returns**?
- Risk reduction – **alternative uses, attractions**
- Spread risk - **more units**, more tenants
- Considerations:
 - **Planning** consents and uses
 - The **Building** – defects and building regulations
 - Local **objections** / protests
 - **Neighbour** problems
 - **Contaminant** problems
 - **Environmental**, Conservation Areas, listed buildings

Investment Considerations

- Understand your **market** – increased demand factors
- Location, Location Location
- Do your **research**
- Do your **project costings**
- Do your **final valuation** – know what the building is worth to **YOU** and don't pay more
- Understand and read **leases** and the requirements of the **1954 Landlord & Tenant Act** – recent changes
- Visit web site **LandlordZONE**TM for this information

Investment Considerations

- **VAT** – is the building subject to VAT ?
- **Flats over Shops Scheme** and other tax incentives
- **SDLT** – new tax, new rules and more paperwork
- Building Regulations
 - DDA, Sound Insulation, Thermal Insulation, Fire Barriers and Doors, Emergency Lighting, Fire Alarm Systems, Fire Certificates, Security etc
- Capital Allowances
- Tax Planning – CGT, Inheritance Tax, Company, Private

Managing Tenants

- Be **pro-active** in maintaining **asset value**:
 - **Maintain** the property – preferably at the tenant's expense – service charges (FRI)
 - **Automate** rent collection
 - Act immediately if there's a **rent problem**
 - Fulfil your **legal obligations** – gas checks etc
 - Maintain rents at **market levels** – you owe it to yourself and your descendants

Investment Philosophy!

- **Value Investing** – finding value - buying value – taking the long-term view
- Do not **get carried** away when you buy – don't overpay and buy for tenants, not for you
- Thorough **analysis** – attention to detail, do your homework, learn the lessons.
- Risk Reduction – **Spread risk** with more tenants and have alternative uses, plus attractions
- Plan for the upside, always **be mindful of the downside**



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Commercial Property Investment Guide 2004

- Investing in commercial property for the first time ?
- Written by Kevin Smith and Richard Bowser - Editor of [Property Investor News](#) - 68 page - A4 booklet.
- [Purchase \(£29.95\)](#)
[LandlordZONE™](#)

