Commercial property investments: Discussion with Strettons - TAB U Podcast - S2 E12 - #TABUniversity

Podcasts

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Please note: This podcast was recorded prior to the announcement of the Chancellor's 'mini' budget and the subsequent market volatility.

TAB University host Katrina is joined by Sam Morris, lending associate at TAB, and Jonny Doulton, capital markets director at Strettons.

This episode is on commercial property investment. The top five questions we asked Jonny were:

1. What are commercial property investments?
2. What type of commercial property is most profitable?
3. Do commercial property investments require a lot of management?
4. Is commercial property a good investment right now?
5. What is your role within Strettons?

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1. What are commercial property investments?

Commercial property investments are properties which are fundamentally income producing. Whatever anyone buys or sells will always be the property, the physical building whether it be land plus building plus a stream of rent or direct income.

Anyone can invest in commercial property. People tend to directly invest either in their personal names or in limited companies. Sometimes people buy as part of syndicates or people might buy a REIT, so a real estate investment trust, which will be a plc so you'll be able to buy that on a stock exchange.

There's a whole host of different ways of doing it and all of my clients have different profiles. I'm on the brokerage side of things, so I help clients buy and sell commercial property investments from a whole range of sectors. So it might be looking at retail property investments, distribution warehouses, hotels, supermarkets or shopping centres.

We take on anything that isn't a residential property, some of the most quirky investment properties we have dealt with include funeral homes to dental surgeries.

A business that owns the freehold of their property can raise capital for the business through a sale and leaseback - they sell the property but lease it back to themselves at the same time. They have the benefit of the property for however long they want it.

My clients already know what structure they want to go down. They might be an existing property company or a developer, for example, and all the land or buildings they buy go into their wider structures or maybe they've set up a dedicated company structure for an individual property they are buying.

Every structure is different. Charities, for example, don't have to pay stamp duty, and they also get savings on their transactional costs if they buy a commercial property investment.

2. What type of commercial property is most profitable?

It's very difficult to quantify. Commercial properties are priced on different factors, such as what the property is, where it is, what the condition of the building is, and what the income profile looks like.

If it's a single let property to Tesco with a 25 year lease, then that is seen as very attractive. However, you might have a multi-let estate or a high street parade where you have multiple tenants, and then rather than terms certain on one tenant, you're looking at a WALT - weighted average unexpired lease term. It's your blended income profile.

There is a reverse correlation - the higher the price that you pay for something versus the rent that you're going to receive as landlord, the sharper the yield. When people talk about bigger yields or higher yields, they're actually talking about paying less money for the property.

Typically a landlord is going to want to get all of their rent. Any threats to that means that they might have a rental void, which means the property turns from being a property asset to a property liability. The property will still have maintenance costs and business rates, which are both still payable even if the property is vacant, unless it is listed. Although listed buildings have their own set of problems, especially when you want to do works and can be held back by English Heritage who can be quite specific with what needs to be done.

We do also look at mixed-use developments, for example a building with short-medium income of four or five years, and then the business plan would be that as the leases ran down they would get planning consent to vary the lease type, maybe from a retail department store to residential flats, student accommodation or a hotel.

We are currently selling a commercial property in Wimbledon that comprises seven shops and flats above. When we first took it on a number of the flats were let with both retail on ground floor and the residential uppers on the same retail lease. The retailers sublet some of the flats above and get residential tenants in them, whereas others have been demised purely as residential flats. A purchaser of that scheme might consider buying all of the retail income and then selling off the various flats to boost overall returns, or keep them long term and refurbish them with the rents going up over time.

It comes down to the landlord and what they want to do in terms of their business plan. Some will just want to be passive and take the rents, others will be laser focused on ensuring their property is best in class, getting the best tenants and the best rents.

Lots of clients within the wider business of Strettons have controlled their property portfolios for a long period of time, especially if it's from a family trust. From client to client though it does vary on how much you need to help them make certain decisions.

3. Do commercial property investments require a lot of management?

They can do, they don't have to. If it's a very long lease to the government, for example, the rent review profiles go up in line with the retail price index every five years. As a landlord, if the property is a driving test centre or if it's a government office building or something like that, you'll get quarterly rents, and then hopefully over time with that rent review structure, the rent will gradually track up and your yield on your money will get better and better.

But that's the top end of the market in terms of the government is the lender of last resort, they cannot go bust. But then if you were to also look at a long lease to Tesco or Sainsbury's or Premier Inn or any large blue chip covenant, if they've got a long lease, and by that I mean probably 15 years without break, then there'll be very little direct management to do on a day to day basis.

It's more when you're looking at multi-let properties or properties which are in need of refurbishment or if you're wanting to look at change of use angles and things like that, then you need to be a bit more hands on in terms of bringing in more consultants and cost consultants as well. So you might bring in quantity surveyors to work out what it's going to cost you to turn that shop into a range of other flats or whatever it may be.

It's about managing the level of risk which is suitable to each client. For example a pension fund would want a low risk variable, whereas a private equity group would be looking to buy, develop and sell within a certain timeframe.

The commercial market at the minute is going through a transitionary period. The last decade or so the interest rates have been falling, due to various government policies to protect the wider economy. These rates have been artificially low for a decade, and it is now starting to re-base and normalise. 12 years ago I was paying interest rates of 5.60% on my property but now we're now looking at interest rates moving to 3.00/3.50% over the next year or so. The pricing will get slightly softer compared to what it was previously, however a lot of money has been printed over the last few years, and a large component of it is sitting in cash, being held by people who are nervous about deploying their money from individual households to larger private equity groups.

4. Is commercial property a good investment right now?

Commercial property is always a good investment, with the caveat of understanding what you're buying. Many people make the error of deploying capital into parts of the market that they don't fully understand. For example, in the last 15 years retail property has been hugely disrupted by the changes in shopping habits and online spending, causing pressure on high streets, meaning rents have been falling backwards. When I first joined the best properties would command yields of 4.50-5.00%, now those same properties, with probably shorter leases, might yield 7.00% or 8.00% depending on the lease.

Conversely, these online businesses now have a huge demand for warehouses, especially over the last decade whether it's 4,000/5,000 square foot or a million square foot, let to Amazon, or someone like that.

The yields on those have compressed down to below 2.50% in some cases, whereas those same buildings ten years ago would be bought at 7.00/8.00%. As the yield compresses, the capital value goes up dramatically.

The rents on the highstreet have been going backwards but rents on warehouses have been rocketing. The tailwinds that warehouses have been benefiting from are still there, but I don't think the trend will continue in the same way. I think there will be a tipping point where the direct economics where tenants will need to be paying rents that are sustainable for the businesses that are using those buildings.

There are other areas of the market that are coming through, such as student accommodation or BTR (build to rent) or PRS (private rental sector) which is where owners of residential developments purposefully choose not to sell individual flats but hold on to them as a long term stream of income.

ESG is at the top of a lot of fund manager's buying criteria in terms of focussing on the sustainability of the buildings that go into their portfolios. There's been a lot of concern about having to do major works to keep their buildings compliant, especially considering the government plans to get us on the path to net zero. The environmental part is typically in the costs of running the building. A low scoring EPC (energy performance certificate) building will have a long term impact on the costs, maintenance and insurance.

5. What is your role within Strettons?

I'm head of capital markets at Strettons. Certain leasebacks fall into my domain, as does buying and selling.

Strettons has a prominent presence in the world of auctions. We also have agency teams dealing with city fringe offices and warehouses and retail units - these teams also transact but typically at a lower property asset value than the things I tend to deal with, which start at 2.5/3 million, rising upward with no top cap.

The largest transaction that I've worked on was a portfolio of 120 petrol stations with convenience stores. We bought the package with vacant possession but the business plan was to take the properties and refurbish and extend them into a full convenience store, such as a small supermarket. We knew that we could let 90 of them straight away, with 20 year leases. We sold the other 30 developers in the petrol trade. The portfolio for the 90 sites when we bought it was circa £100m but by the time we'd finished with it, it was closer to £200m.

It was just before the great financial crisis, so it was an interesting time. We were due to present the proposals back to the client, but the day before Lehman Brothers collapsed. Banks stopped lending because of that, and all of our bids fell over as they couldn't get the finance terms they wanted. It was a huge whirlwind and we were questioning if our business was still sound and secure. We had to spend the next two years breaking that portfolio of 90 down into bite-size chunks and selling them a single deal, or four or ten properties at a time. It was a rollercoaster, but because we'd gotten 20 year long leases, they were long, strong, defensive profiles of income, and the market was chasing them for wealth preservation as well as wealth generation.

Do you need to be qualified?

Most investment agents are chartered surveyors, having gone to university to study a property course and become accredited by the RICS (Royal Institution of Chartered Surveyors). They come back to the market as graduates and train for several years, then sit their APC (assessment of professional competence). I was on that route, and working towards becoming chartered when the financial crisis kicked off. I just kept focussed on the job and over time my personal CV got padded out by doing more and more deals. I reached partner level and then moved over to Strettons.

Given the hurdles for people coming through into surveying today, you absolutely have to be chartered. But there are other qualifications and skill sets you need to do the job well. Your financial modelling has to be strong, you need to be able to engage with your clients and understand their needs and risk profiles, you need to be able to manage processes and teams - investment agents work with a wide range of consultants. Having a strong insight to what you're doing and enjoying it is important. I enjoy the personal dynamics between myself and my clients the most.

You can find Jonny and Strettons at: https://www.strettons.co.uk

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