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COMMERCIAL PROPERTY

The driving principles behind investing in property vehicles

There is no end of property investment vehicles out there but investors should bear in mind the basics of investing in property says Bill Nowlan.

Several questions from clients and friends about Eddie Hobbs ' Brendan' Property Vehicle prompted me to set out some simple yardsticks that one should use in assessing property investment vehicles.

I claim some competence in this area following 27 years running Irish Life's property investment portfolio and my recent 13 years as a consultant property asset manager. In approaching this I always use the word TALIP.

T To start with the 'T' word; T being for Timing and Taxation. Timing is by far the most important factor in making successful property investment. Any fool should have been able to make money in property over the past ten years in Ireland or in most of Europe in what was the most benign economic, financial and political environment ever. Property in Ireland almost quadrupled in value in that period with some sectors above that rate and others somewhat below. The JLL Irish Property Capital Value Index rose by 250% from 1995 to 2005 which equates to an average annual return of 13.34% and this excludes income earned.

However for those of us managing property investments between 1985 and 1995 the JLL index only rose by 28% which equates to an average annual increase of 2.48%

What the next 10 years will bring I do not know but I would say that capitalising yields in Ireland and Europe are now are at an all time low which will almost eliminate the opportunity for further yield compression and an investor will have to rely solely on rental growth for performance. Indeed it is this compression in yields over the past ten years that has given up to 80% of the VALUE growth in that period. .

T is also for Taxation. Property is very susceptible to taxation by government. The buying of property attracts stamp duty which in the UK is at 4% in Ireland at 9% and in some European countries as high as 12%. There is nothing to destroy value like high transaction costs including stamp duty particularly if you are investing for the short term. If the underlying property does make good capital gain one has to think of Capital gains tax. There is little point in making money from risky pretty investment and then handing

up to 40% of it to the government in the form of a double whammy of capital gains tax firstly within the investment vehicle and then in the hands of the individual investor. This is why most investors like to buy in their own name rather than through a limited company. The problem is that a limited company pays CGT on its disposals and then the investor pays income tax on dividends and CGT again on the cash realised from selling his shares.

Some investment managers claim to be able to eliminate the first layer of corporate tax by fancy footwork or smoke and mirrors and some have been successful. But governments are continuously blocking these routes and with property being a long term investment, one can be a sitting duck for the taxman's posy. I have discovered this the hard way over the years...

A For the 'A' word I look to alignment. The manager of the fund must have his interest 100% aligned with the investor and this includes entry and exit costs. If the manager's remuneration package is not fully aligned with those of the investors then watch out for trouble. The manager should ideally be capable of being fired by independent persons representing the investors in much the same way as independent directors can fire the officers of a PLC who are not performing. If the manager of a property fund has secured a sweet deal - come what may - at the expense of the investors, then watch out. This alignment issue is critical and is where I would criticise many of the new entrants into the property investment scene.

L The first L is for location. The old adage of location location location is as true today as it was 100 years ago. The location issue can be location in a country, a city, or street. The skill of the manager is in selecting the right location for an investment and of course the timing of that investment is paramount. There are good stock pickers and bad stock pickers. Beware the manager whose approach to location and purchasing is to fly into a foreign city, be wooed by the local estate agents and buy the local agents recommendation. Agents are brokers not asset managers. How to pick a good manager is by looking at his track record.

For those conversant with the IPD portfolio analysis techniques the decision of a manager in selecting individual properties can be analysed and when the result is striped away from the general market performance, one can see if that manager is actually making or losing money by his location decisions. A good manager should be producing this type of information. Don't be fooled by a manager who claims to have made money by just happening to be in the right place at the right time- although there is a role for lucky managers and I will come to that in a moment. Property managers should be picked on the basis of their proven skill in out performing the market.

L is for luck and for liquidity. Just like Napoleon wanting lucky generals I like lucky managers- but ones who have proven their luck by their considered decisions and not by chance or being in the right place at the right time. Investing in property is not like just picking a horse with a pin. That luck should be supported by detailed research of the markets and the locations that he eventually chooses. Indeed no amount of luck can overcome bad timing or an economic downturn.

L is also for Loan for Leverage and for Liquidity
The big money made out of property investment is by leveraging up your equity by way of a loan secured on the asset. From the simple house owner with a building society mortgage to the property tycoon - all know about this concept. When property values go up, your loan remains fixed and hey presto you have made money by just being at the party. What is forgotten sometimes is that leverage can work in reverse if property values fall or if interest rates rise above the income stream from rentals. This happened in Ireland to some small extent in the late 1980's and to a large extent in the UK in the early 1990's and many property investors and owners can tell the tale of having negative equity in their holdings and having to take the pain of paying interest on a loan greater than the value of the property or if selling to coughing up the difference.

Liquidity is the other L factor. It is very easy to forget that property is a long term investment and one can get locked into an investment for a long period. The advantage of owning a property directly is that you can decide to sell whenever you want. Also if you own shares in Publicly Quoted Company you can sell the shares. But if you are in a syndicate or an unquoted investment vehicle one can get locked in until the investment manager disposes of the properties. For the small investor this can be quite a problem and needs very careful consideration especially if you are at or past middle age. One way of overcoming this is that most, but not all, of the funds run by the Life companies allow that one can generally exit at relatively short notice.

I is for interest rates and for income. Many people seem to think that the fundamentals of property are about capital gain and forget about the income side of the equation. In a period of what I would call normality it is rental income that pays the pension or the mortgage. History shows that good property investment is characterised by a long period of steady income flow with occasional sudden increases in capital value. Very boring stuff but generally good property investment is boring - collecting the rents and keeping the customers (tenants) happy That capital value adjustment being brought about either by scarcity of accommodation causing rents to rise or a change in the yield spectrum which can be up or down.

P is for Passion and People. Successful property investment is about the people selecting, managing and then selling the assets. If the People don't have the Passion and commitment to make it happen, then don't invest with them. In selecting an Asset Manager loo into his eyes and see if there is a burning fire there. If not then maybe he is only an administrator who wants a deal fee.

Bill Nowlan is a Chartered Surveyor and Town Planner. He was Property Director of Irish Life for many years and also lecturer and Visiting Professor at University of Ulster. He has run a property asset management advisory consultancy firm for the past 13 years.