The M&G guide to
Property

Contents

Please refer to the glossary found on page 13 for an explanation of the words highlighted in **bold** throughout this guide.

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise and you may get back less than you originally invested.

We are unable to give financial advice. If you are unsure about the suitability of your investment, speak to a financial adviser.

The views expressed in this document should not be taken as a recommendation, advice or forecast.

What is commercial property?

Commercial property in brief

Commercial property is part of our everyday lives, as this **asset class** includes the places where we work, shop and relax.

There are three main types of commercial property: retail, office and industrial.

Retail property

This is the largest section of the commercial property market and consists of shops, shopping centres and retail parks, which contain a mix of retail outlets.

Office property

This includes business parks as well as office buildings.

Industrial property

This covers factories, distribution warehouses and industrial estates.

Who uses commercial property?

Commercial property covers many different types of buildings, but there is arguably even more diversity in the types of occupiers. Virtually all industries and businesses use commercial property, varying from small locally based companies to multinationals and even governments.

- Commercial property refers to buildings being used by businesses
- Three main types of commercial property are retail, office and industrial
- You can also invest in several other areas, from hotels and health centres to cinemas

The benefits of investing in commercial property

The potential for income

The main source of return from commercial property investment is normally the rent paid by the tenants – over the long term, this is likely to make up most of the **total returns** you may achieve.

Rental payments are made on a regular basis as set out in the **lease** agreement, just as they are when people rent residential properties. However, commercial property has two big advantages over residential property. The leases tend to last much longer and there is usually a better chance of the rent being paid, as businesses are generally more reliable tenants, with access to larger sums of money.

Leases on commercial property can be for five or ten years – sometimes even longer – which means a commercial property investment offers the scope for a predictable, regular income that lasts the life of the lease. What's more, rental rates are normally reviewed every five years and, in many cases, the rent can only be revised upwards.

The potential for capital growth

Commercial property also has the potential for **capital growth**, meaning that if the property were to be sold, the investor may receive more than the purchase price. Of course, the investor may receive less if the price were to fall.

A feature of commercial property is that its value tends to be largely based on the reliability of the regular rental income rather than the emotional decisions that can sometimes affect stockmarkets. This is one of the reasons that the performance of commercial property is normally less **volatile** than some other types of investment.

- Commercial property offers the prospect of a reliable income
- Over the long term, this is likely to make up most of the total return you may achieve
- You may also get some capital growth, as properties can rise in value. However, they may also fall in value

Property compared with other types of investments

Should you choose property over bonds or equities?

When it comes to choosing where to invest, the option you go for is likely to depend on how you feel about risk and what you need from your investment.

Bonds are generally lower risk than **equities** as there is an obligation to pay the bond holder back the original amount they invested. Bonds provide a regular income with more growth potential than cash.

Up to £85,000 of your money is secure in a bank or building society through the Financial Services Compensation Scheme, unlike stocks and shares or fixed interest investments which are less secure.

Property offers the combination of a stable, long-term income and potential for some growth.

Equities have the potential for strong growth, but also come with the possibility for greater losses as their value fluctuates more and there is no obligation to pay the shareholder back the original amount they invested.

Property can also be an appealing way to increase the level of **diversification** in a portfolio focused on equities and bonds. This is because it tends to perform very differently when market or economic conditions change. Diversification is a useful way to reduce risk in a portfolio.

- Cash savings are perceived to be the safest way to invest, but returns are not high
- Property has the potential for greater total returns than bonds over the long term. However, it tends to have less growth potential than equities
- Bonds offer the potential for a regular income and tend to be lower risk than equities but have less chance for strong growth
- Equities (also known as shares) are higher risk than bonds, property and cash, but they also offer the most potential for strong growth
- Costs associated with buying and selling properties are generally higher than those for equities and bonds

Understanding how commercial property can rise or fall in value

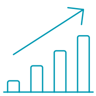
There are four key factors that affect the performance of a commercial property investment.

Supply and demand

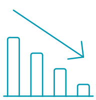
When the economy is doing well, businesses prosper and look to expand, which means they need more space. This extra demand means that tenants will be prepared to pay higher rent, which generally feeds through to higher property values. In contrast, a downturn means businesses are likely to cut back on expansion plans or even reduce the number of people they employ. This can depress rents and property values.

These effects are exaggerated by the time it takes to build commercial property, as the construction of new buildings often lags behind rising demand. Equally, when demand falls away, the buildings are still there, so there may be more available than are needed.

Property values rise:
More investors want to buy but fewer investors want to sell



Property values fall:
More investors want to sell but fewer investors want to buy



The financial strength of the tenants

If a tenant is financially strong, they are less likely to default, so rental income can be more secure. A longer lease also means greater security for the owner. This is important because default is one of the key risks in property investing. After all, if a tenant goes bust, the rent stops being paid and the owner's costs rise.

- Commercial property is affected by supply and demand
- Location and quality are also important
- A tenant that defaults (in other words, doesn't pay their rent) can significantly affect your returns
- It can be difficult buying and selling property compared to other types of investment

Location and quality

The highest-quality buildings in the best locations (which are known as **prime property**) attract the highest rents. However, a property's status can change. For example, a prime retail shop might be downgraded if it is not looked after by its owner or if a new shopping centre up the road takes away some of its customers.

Of course, there can be positive changes as well, such as an industrial property being turned into a retail warehouse, which normally means it can charge higher rents.

The difficulty in buying and selling property

Unlike many other types of investment, property is quite difficult to buy or sell. The process takes time and there is no guarantee either that buildings will be available to buyers or that sellers will be able to find a buyer. (To use the technical term, property is less '**liquid**'.) This can mean that, if a property needs to be sold quickly, its value can suffer. Also, buying property requires a large initial investment.

How to invest in commercial property

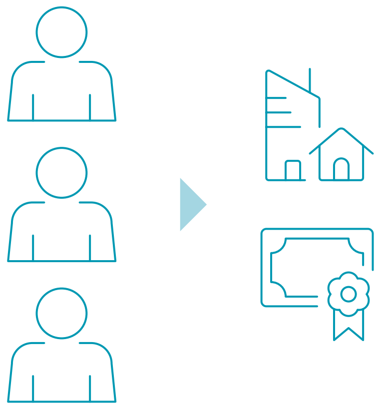
Direct

You can buy and manage commercial properties yourself, though it's likely you will need a significant sum to get started – and you may be relying on the performance of just one or two buildings.

invest directly

Property company shares

You can buy the shares of companies that own, manage or develop property. If they do well, their shares should rise in value. The companies may also pay a **dividend** to shareholders, which would provide you with an income. However, over time, the returns from property company shares tend to be more variable, or volatile, than a direct investment in property.



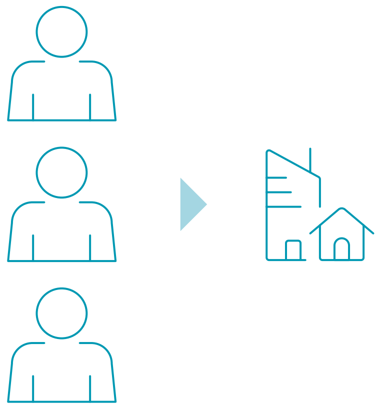
invest in company shares

- You can buy commercial property yourself
- You can buy shares in companies in the property sector
- You can put your money into a fund that invests in property

Property funds

A fund manager invests your money in commercial property on your behalf. This gives you the benefit of the fund manager's experience and expertise, as well as the resources of the investment company they work for. Some property funds buy buildings and manage them (these are known as 'bricks and mortar' funds), while others focus on property company shares.

If you are interested in commercial property for its income potential or lower level of risk, you may need to take care when choosing where to invest. Although property company shares are in a position to benefit from the income generated by the properties they hold, in the shorter term, their returns are usually more like the performance of shares – which means they involve a higher level of risk. If you're not sure about the suitability of an investment, you should speak to a financial adviser.



invest through a fund

Types of property fund

Choosing the structure of your fund

This section of our guide explains some of the legal structures of property investment funds. This information is important as there can be significant benefits in choosing a fund with the right structure for your needs, particularly if you plan to hold it in an Individual Savings Account (ISA). Please note, ISA tax advantages depend on your individual circumstances and ISA tax rules may change in the future.

Three types of fund

1. Property unit trusts

A property unit trust is simply a fund that invests in property, where the investors own a specified number of units depending on how much money they have invested. The value of the units depends on the value of the properties in which the fund is invested.

2. Real Estate Investment Trusts (also known as REITs)

These are investment companies that own and manage property. This means they have a share price that can be different to the value of the properties they hold (as the price is affected by supply and demand). They must pay out at least 90% of the taxable income they receive to investors in the form of dividends.

3. Property Authorised Investment Funds (PAIFs)

These are similar to unit trusts, but have a legal structure that makes them more tax-efficient for certain investors.

How PAIFs can give you more for your money

‘Bricks and mortar’ unit trusts have to pay 20% tax on the income they receive from rent, which reduces the amount they can pay to their investors. However, PAIFs leave tax payments to the investor.

This means that when a PAIF is held in an ISA (where you don’t have to pay tax on investment income), the income from a ‘bricks and mortar’ PAIF can be considerably more than the income from a comparable unit trust.

There are several different legal structures that property funds can use, which affect how they are set up and how they are taxed.

These include trusts, Real Estate Investment Trusts (REITs) and Property Authorised Investment Funds (PAIFs).

A few questions to ask before you invest in a property fund

Does the fund meet your needs?

There are many property funds out there and their names aren't always that informative. However, you can get an idea of the growth potential and risks by looking at the investments a fund makes and the company that runs it.

Where does the fund invest?

A good place to start is to check how varied a fund's holdings are. This doesn't just mean the number of properties it holds, it's where they are located, what size they are, how many tenants they have and what sectors they serve.

A broad spread of properties means a fund can cope much better with a downturn in any one area – and having lots of tenants means you aren't relying on the fortunes of just a few businesses.

- Is there a range of property types in the fund?
- Does the fund have some cash reserves?
- How does the fund manager plan to increase the value of their holdings?
- Does the fund manager's company have the necessary resources?

Is it making the most of its properties?

If most of a fund's properties are occupied (in other words, it has a low vacancy rate) and its tenants are on longer leases, this means the fund is less likely to experience a sudden drop in rental income.

Equally, it's good to check that the fund manager is doing everything they can to maximise returns. For example, they could refurbish properties, change planning use or improve their leases.

What about the fund's size and resources?

At the most basic level, a larger fund is able to buy bigger properties – so it has more options to choose from. However, a well-resourced and highly experienced team also has more market knowledge and better access to opportunities.

Glossary of investment terms

The following are explanations of some of the terms you would have come across in this guide.

Asset Anything having commercial or exchange value that is owned by a business, institution or individual.

Asset class Category of assets, such as cash, company shares, fixed income securities and their sub-categories, as well as tangible assets such as real estate.

Bond A loan in the form of a security, usually issued by a government or company, which normally pays a fixed rate of interest over a given time period, at the end of which the initial amount borrowed is repaid.

Capital growth Occurs when the current value of an investment is greater than the initial amount invested.

Commercial property Any property that is used for business purposes. The three main sectors are retail, industrial and offices.

Default When a borrower does not maintain interest payments or repay the amount borrowed when due.

Diversification The practice of investing in a variety of assets. This is a risk management technique where, in a well-diversified portfolio, any loss from an individual holding should be offset by gains in other holdings, thereby lessening the impact on the overall portfolio.

Dividend Dividends represent a share in the profits of a company and are paid out to the company's shareholders at set times of the year.

Equities Shares of ownership in a company.

Lease A contract between a landlord and a tenant. It sets out the terms for the tenant to occupy the property.

Liquid A company is considered highly liquid if it has plenty of cash at its disposal. A company's shares are considered highly liquid if they can be easily bought or sold since large amounts are regularly traded.

Prime property A prime property is likely to be finished to a high standard, have a commercially attractive location and be let to a financially sound tenant.

Risk The chance that an investment's return will be different to what is expected. Risk includes the possibility of losing some or all of the original investment.

Total return The term for the gain or loss derived from an investment over a particular period. Total return includes income (in the form of interest or dividend payments) and capital gains.

Volatile When the value of a particular share, market or sector swings up and down fairly frequently and/or significantly, it is considered volatile.

The M&G guides

The M&G guides aim to give you the basics about investing, to help you make informed decisions about your financial goals and how to reach them.

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