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Commercial Property Guide

Commercial Property as an Investment Asset, and the Concept of Yield

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This article takes a look at the role of commercial property as an investment asset, what investors mean by the concept of "yield", and the significance of commercial property to an institutional investor, such as a pension fund.

Commercial property provides the owner with a capital asset, which is expected to do two things:-

- produce an income, in the form of rent paid by the tenant(s);
- provide capital growth, in the form of enhanced capital value, during the period of ownership (although in adverse market conditions values may fall as well as rise).

The capital value of a property will depend on a combination of factors, the principal ones being

- the income that the property generates (and the potential for that income to increase);
- the reliability of the current income stream, that is to say the quality of the current tenant covenant (for instance, a property investor will be willing to pay more for a property with a "blue-chip" tenant than for the same property with a tenant covenant of lessor substance);
- the location of the property and its use;
- the condition of the property;
- legal issues affecting the title to the property (for example covenants restricting the use of the property).

Commercial property is generally regarded, in terms of investment opportunity, as "illiquid" in comparison with other investments such as shares, gilts, etc. – that is to say, it may take a comparatively long time to acquire or dispose of commercial property.

The commercial property market, like many other investment markets, such as the stock exchange, is cyclical, it can go through periods of rise and fall, meaning that depending on when a property is bought or sold, either a substantial gain or substantial loss can be made. There is, therefore, considerable scope for the exercise of skill and experience when dealing with commercial property, so as to maximise the gain achieved.

Investors often refer to the concept of "yield". Yield is essentially the income return that the owner receives from the property, and can be described as a percentage which the income of the property (that is to say the rental income from the tenant(s)) bears to the price paid for the property. Where there is a blue-chip tenant in place, generally the owner can expect a lesser yield, because of the safety of the income stream (sometimes as low as 2% in prime locations).

An "institutional investor", such as a managed pension or other investment fund, normally invests in a range of different assets, which will include shares, gilts and property. The investor's portfolio will generally need to maintain a balance between these types of investment, and the percentage that commercial property forms within a particular portfolio is likely to be in the region of 10% (or slightly less, although some investment funds will have no property investments at all, while others will be specifically property-focused and carry more).

Therefore, if share prices fall, some property within the investment portfolio will need to be sold in order to maintain the overall percentage of property within the portfolio, and if share prices rise, more property will need to be acquired.

Other factors in the decision making process as to sale and purchase will be the wish of the investment fund to achieve a spread of investments by reference to property use, geographical location and other similar factors, which goes some way to explain why one investment fund may wish to sell a property at the same time as another investment fund may wish to buy that property.

*For further information, or for a discussion about the role of commercial property as an investment asset, and the many issues to consider from the legal perspective when acquiring, disposing of, or letting commercial property, please contact any member of our **Commercial Property Team** or click on **Contact Us** on our website and submit a contact request.*

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