RESIDENTIAL OR COMMERCIAL?

Many investors are familiar with commercial property as a source of competitive risk adjusted returns with low correlation to other major asset classes like gilts and equities. Commercial property has formed part of multi asset portfolios and pension schemes for many years. Residential property is seen as a 'new' asset class by many, but up until the 1960's some UK insurance companies had significant holdings and at approximately £5 trillion, the size of the UK residential property market dwarfs the commercial property market.

There were barriers that led institutions to divest from residential property but these have been removed in recent years with changes to tenancy agreements, the growth of large-scale, nationwide property management companies, the disaggregation of Stamp Duty Land Tax (SDLT) and the continuing shift in tenure type towards the private rented sector.

Independent research from companies like the British Property Federation, IPD and Acadametrics suggests residential property also offers robust risk and return characteristics from a similarly uncorrelated asset class, but are they the same?

In short no, there are numerous differences that need to be considered and we will aim to summarise some of the key areas. For the purpose of this exercise we are comparing a portfolio of private rented UK residential property with a balanced portfolio of UK commercial (shops, offices and industrial) properties.

Valuation

The valuation of a portfolio of private rented residential properties will be based on capital values, typically at a discount to vacant possession (VP) value if the property is let. The application of a discount to VP value stems from the historic relationship between landlords and tenants where the tenant had much greater security of tenure which made it difficult for landlords to remove them and gain possession of their property.

The introduction of Assured Shorthold Tenancy agreements (ASTs) in 1988 rebalanced the landlord/tenant relationship and provided landlords with clearly defined rights of repossession. When valuing a residential property a surveyor will have access to Land Registry data on recent transactions for similar properties in the same locations, so values provided should be reasonably accurate.

The value of a commercial property is essentially driven by a capitalisation of the rental income it generates. The attractive yields generated by commercial property are seen as the primary source of returns, with expectations of capital growth often somewhat lower than residential.

Tenancy Agreements

Residential property is generally let under ASTs with the responsibility for maintenance of the property falling to the landlords, who thus have to pay on-going maintenance and management costs out of income received. The minimum term under ASTs is 6 months after which the landlord can regain possession of the property having given the tenant 2 months' notice.

Commercial property is normally let on a Fully Repaired and Insured (FRI) basis with the tenant responsible for on-going repairs and maintenance and is usually subject to longer term leases (typically 5-10 years) than in the residential sector although many leases will have break-points at certain anniversaries and rent reviews, which are generally on an upward only basis. The longer term nature of commercial tenancies can provide relatively secure and steady cash flow however as the structure of buildings age and occupiers' preferences change commercial properties can quickly become functionally obsolescent.

These differences in valuation and tenancy arrangements also explain why the net yields from commercial property will often be higher than from residential and also why investors might anticipate a greater element of capital appreciation from a portfolio of residential property.

Liquidity

Residential and commercial properties are both physical assets and hence less liquid than assets traded on exchanges. Residential property offers better liquidity due to the difference in size of the market, lot sizes and volumes of sales. The shorter term, and rolling, nature of ASTs also gives a residential property fund manager more flexibility should they need to realise assets.

Stamp Duty

The costs associated with buying physical assets like property can be higher than other assets, although the disaggregation of SDLT on bulk purchases of residential property means large scale investors pay tax on the mean, rather than the aggregate value of purchases. In effect a residential property fund could buy several millions pounds worth of property but only pay a low rate of SDLT, whereas a commercial property fund manager would likely pay 4% on most purchases.

Availability

One area where commercial property currently has an advantage over residential property is the number of established and regulated funds available. Investors seeking access to a diversified portfolio of residential property have limited options, whilst investors seeking similar exposure to commercial property have numerous funds available to them.

Benchmarks

The primary benchmarks for commercial property are provided by IPD whose property indices are based on valuations and not actual transaction prices, which suggests that they may at times underestimate the true volatility of the market.

There are a number of indices against which the residential property performance can be assessed, some of which are based on asking prices or mortgage offers. The availability and use of Land Registry data that details all completed transactions, including cash purchases, provides a very accurate insight in to the actual performance of the UK residential property.

Performance

Whilst the dynamics and characteristics of the two are quite different the performance characteristics are similar and there is a fairly strong positive correlation of returns. Historically, commercial property values have tended to react quicker to negative changes to the economic environment and research suggests that residential property is less volatile than commercial, this being said, it is not immune to the effects of challenging economic conditions, with current house prices in many regions still below the peaks of 2007.

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Government Support

Whilst the improving economy is good for both commercial and residential property it is fair to say that the housing market is benefiting from direct political support.

The current government has been pro-active in not only seeking to support the housing market by stimulating demand through the 'Help to Buy' scheme. It has also been active in trying to address the huge shortage in the supply of new housing both in the private rented and affordable housing sectors through initiatives like Build Now Pay Later and Get Britain Building, designed to encourage large scale investment in to residential property. Concerns have been raised about the creation of an artificial property bubble however the huge mismatch between the supply and demand in residential continues to present challenges but also opportunities for investors.

Summary

We believe the evolution of residential property as a bona fide asset class for investors will continue. Already we have seen several councils working with private sector partners to invest in residential property and the asset class has also attracted interest from Swedish and Canadian pension schemes.

Comparisons with commercial property are inevitable and rightly so. Many investors will already be familiar with commercial property as an asset class but may be less so with residential. It would be easy to assume that these two 'bricks & mortar' investments worked in the same way but clearly this is not the case and we hope this article provides a reasonable starting point for further analysis.

The different characteristics of each suggest to us that combining the two within multi asset portfolios provides the potential for robust risk adjusted and uncorrelated returns from investing in tangible assets that are familiar to all.

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