As an investment commercial property is unique compared to standard stocks or bonds. They have a large individual value, are non-standardised, and can be improved by pro-active management. Unlike other investments dealing in property requires a certain degree of expertise due to the subjective nature of the market; one cannot simply walk into a stock exchange and check the market rate for office rents in a certain place, because such an exchange does not exist. Equally one cannot generally afford to front several million for prime commercial property; as such debt is key in keeping the sector moving. Property transaction and rental data must be sought out by surveyors when determining the value of nearby property; this can often be laborious and time consuming, hence the requirement for expertise in the field.

Commercial property incomes stem from two intrinsically linked sources; rental income and yield. The rental and capital values of property are based on the level of risk the property is exposed to. The level of risk is known as the yield; this is a representation of how good or bad a tenant is deemed to be. The yield is the percentage of the capital value of the property at the point of being leased which is to be received as rental income. A low yield, say 5%, would indicate a stable tenant, who is perceived to be capable of fulfilling their covenant throughout the term of the lease. A higher yield, say 10%, would indicate a poor tenant, one who may default on paying their rent. In enforcing a higher yield, a landlord is attempting to ensure they obtain as much rental income with the expectation that the tenant will not see out the full lease period. The yield is a percentage of the overall capital value of the property, and is key in determining a properties capital value in terms of years purchase in perpetuity (YP), by dividing the yield into 100. For example, a rent of £10,000 per annum on a 5% (low risk) yield is valued at 20 years purchase; £10,000 times 20 YP gives us a capital value of £200,000. A high risk yield, say 10%, would be 10YP, giving us a capital value of £100,000. High risk tenants therefore reduce the overall capital value of a property, as they are not expected to be a paying tenant for the entirety of the lease term. A lower risk tenant is therefore preferable. Rent is reviewed at intervals specified in the lease, traditionally every five years. There is a tendency to include a clause in the lease for upwards only rent reviews; this can cause problems during times of economic uncertainty, as rental growth underpins the value of and investment in the commercial property sector.

To measure the performance of an investment one must look at the rise and fall of rental value, yields, and whether rent reviews or reversions are imminent. Rent can rise or fall due to a number of factors. There may be an increase in desirability of the properties location, perhaps due to a major corporation moving in nearby. By having neighbours with higher rents, the rental value of a property will increase. A shortage of commercial property may lead to an increase in rent due to supply and demand; landlords can charge more due to the lack of available space. The property market may be providing better returns than alternative investments, leading to an influx of money into the sector. As a result there will be too much money chasing too few investments, causing the capital value of property to increase. However if this slows and money starts to be invested elsewhere yields will fall. This will reduce the capital value but not the rent. An increase in rental value increases the yield, in turn increasing the overall capital value of the property. Likewise, low rental growth will increase the yield and reduce the overall capital value of the investment.

Of course, a property is nothing without tenants to occupy them. A scheme of proactive management of property is necessary in order to attract and retain good tenants. By carrying out planned maintenance, ensuring repairs are completed swiftly, and keeping an eye on development opportunities, tenants are retained, and the income flow is maintained. If a property is in good nick we can reasonably charge market or above market rents. Due to advances in technology and consumer sentiment it is important to redevelop to stay in line with current property trends. Redevelopment of the British high street from the 2000's onwards is a prime example of this. The construction of modern shopping malls, such as Stratford Westfield, Hull St Stephens, even High Wycombe's Eden Centre are prime examples of regeneration up and down the country. Croydon is currently undergoing a £5.25bn regeneration programme spearheaded by Westfield and Hammerson's redevelopment of The Whitgift Centre. Savills in 2015 projected an increase of 63%

over two years in the office rental sector, up from £24.50 sq/ft to £40 sq/ft.[1] This shows the impact high profile redevelopment has on existing commercial property stock.

So when revaluing a property ahead of a rent review or reversion, we look at the transaction data for the geographical area and the type of property we are valuing. Of course no two properties are the same; this is part of what makes property such a good, unique investment. One share in a company is worth exactly the same as another, but one office block is not the same as another. They occupy different locations with access to different amenities. As they are buildings constructed at different time periods they have wildly different aesthetics; compare an office block built in the 70's or 80's, all concrete and open plan floors, to a modern office development fashioned from plate glass and steel, with sweeping atriums and a focus on aesthetic over people per square foot. Building characteristics hold different levels of desirability to potential tenants. For a small retail company with a low turnover an office in London's suburbs may suffice, however an investment bank would require a central London office given the prestige of their business. To value a commercial property a surveyor looks at similar transactions over a period, calculating the average to determine what the market rent would be. This requires a mixture of first hand investigation, and reviewing data held by the big property companies like CBRE and Frank Knight. As previously discussed if rents rise, yield falls, and overall capital value of the property increases. At the point of a rent review the idea is therefore to obtain a higher rate than the property currently generates. If not possible the rent will usually stay the same due to upwards only rent reviews in the terms of the lease. In this manner it is important for a good estates manager to proactively prepare and research for rent reviews and reversions to secure the best rental income and increase the capital value of the property. Where a property is not likely to secure a good tenant, or rents are falling in the area, a good estates manager must look at either redeveloping the existing building either through refurbishment or total redevelopment to secure a good tenant, or disposing of the property to minimise their loss, and prevent potential default on bank loans by either themselves or their company.

Debt is the lifeblood of the property sector. A developer would never be in a position to fully fund a development; they must obtain loans from banks or other investors, known as gearing. This works in their favour by reducing their initial outlay and increasing the percentage of their returns. For example let us take a property costing £100,000,000 on a 6.5% yield. If a bank funds 70% of the cost at 3.5% interest rate, and the developer the remaining 30%, the interest payable on the loan would be £2,450,000. The overall return on the developers £30,000,000 would be £4,050,000, or 13.5% of their investment. If the developer fully funded the project their return on investment would only be 6.5%. This works out very well for the developer provided there are enough tenants, and property values remain stable or increase. If this is not the case, if a property devalues due to market conditions before the development is complete, a property company may find themselves out of pocket and at the mercy of their creditors.

Unlike other financial markets, the property sector is cyclical, going through boom and bust phases resulting from saturated and desaturated markets. As demand falls, rental growth slows, causing a drop in capital value. With the drop in capital value developments become unviable, and credit becomes difficult to obtain. This slowdown in development inevitably leads to bankruptcy and recession within the sector. When demand picks up, rent increases, capital values rise, and development becomes viable again. The recessions of the 1990's and 2007-08 illustrate the low end of this cycle. Although both were 'bust' periods, they happened for different reasons, and had a knock on effect on the future of the property market.

During the 1990's the UK entered a recession caused by high interest rates, falling house prices, and an overvalued exchange rate. The property sector suffered at the time due to three main factors; asset price inflation during the 1980's led to high property values; a development boom in the 1980's meant a lot of new property entered the market in the early 90's, when tenants were scaling back on their business commitments; and due to cheap credit throughout the 80's developers

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[1]http://pdf.euro.savills.co.uk/uk/office-reports/spotlight-greater-london-and-south-east-offices-january-2016, P4

were severely over-geared, and vulnerable to high interest rates which accompanied the recession. The oversupply of property and shortage of tenants made it very difficult to secure new leases. As empty buildings do not generate any income, developers found themselves unable to pay the interest on their loans. Properties without tenants are very difficult to sell on as they do not generate any rental income, as a result capital remained tied up in redundant properties, which could have been used to pay off outstanding bank loans. When developers were unable to keep up with their repayments, banks seize what is effectively worthless developments; given market conditions it would not be profitable to continue with development, and as such the project would grind to a halt. With a surplus of space and a shortage of tenants, rental values dropped due to availability for tenants. Due to the economic uncertainty of the future, tenants could potentially default on rent payments, meaning yields rose and leases signed at a higher initial return to ensure landlords obtained as much money as possible, resulting in a fall in capital values of property. Yields for city offices rose from 5% in 1989 to over 7% in 1992[2]. This resulted in capital values reducing by half. Leases with upwards only rent reviews caused an overvaluation of property; although the market rate for rental income had fallen, tenants would be kept at the same rate as their previous review. This, combined with a lack of movement in the market, meant valuation of property became difficult, and distorted the market as a result. Inducements, such as rent free periods, or reverse premiums, in which a landlord would pay a tenant a sum to move into the property, further distorted the market.

A similar process occurred during the 2007-08 recession. Unlike the recession in the 1990s there was one primary cause, that being the collapse of the US sub-prime mortgage market. Due to deregulation in the US markets, lenders were giving credit for effectively worthless properties; dilapidated inner city tenements, even motor homes in some cases. This resulted in an estimated £400bn loss, government bailouts for major financial institutions, and a loss of confidence in the credit industry. This in turn led to reduced interest in asset-backed investments. Research by the Association of Real Estate Funds showed an inflow into the UK property market of £1.1bn in Q1 207. By Q4 2007 this had reversed into an outflow of £1.2bn[3]. Transactions also dropped drastically, from £18bn in Q4 2006 to £7.2bn Q4 2007. CBRE's index showed a 14.9% reduction in the capital values of property by February 2008[4]. This resulted in difficulties for developers obtaining funds from major financial institutions, thereby increasing the reliance on overseas and private investors.

Although the 2007 crash was severe, it did not have as great an impact as the recession of the 1990's. Increased interest rates as a result of the previous crash led to developers looking for offshore investors; a prime example being The Shard, which was funded by a group of Qatari investors. In 2007 overseas investors accounted for the majority of purchases in the UK property market. In 1991 14m sq ft of new office space came onto the market, as opposed to 7.9m sq ft in 2007. Speculative development was less than half the amount in 2007 compared to 1990.[5] Therefore the level of risk the UK market was exposed to as a whole was significantly less than in 1990. The sector recovered slowly following the 2007 crash. Since 2000 the average value of commercial property had increased by 3.0% each year, which is still above inflation; however it did not surpass pre-2007 levels until 2015. By 2016 overseas investors accounted for 29% of the £486bn owned by investors in the property market; by comparison domestic investors accounted for 16%.[6]

In conclusion the values of commercial property rise and fall due to changes in rent affecting the overall capital value of property. The cyclical nature of the property market means that in boom periods, rents and capital values rise due to shortage of supply, meaning landlords can command higher rental values. As supply meets and outstrips demand, rents begin to fall, leading to a dip in capital value. Development comes to a halt as the pool of tenants regroups and eventually bounces

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[2]Brett, M. Property and Money', 2nd Edition, 1997, EG Books, London, P289
[3]Ellis, R. Credit Crunch and the Property Market, May 2008, GLA Economics, P13
[4]Ellis, R. Credit Crunch and the Property Market, May 2008, GLA Economics, P14
[5]Ellis, R. Credit Crunch and the Property Market, May 2008, GLA Economics, P52
[6]Property Industry Alliance, Property Data Report 2016, P10

back. Investment and development restarts and brings us back into a position of supply being less than demand, putting the market in favour of the landlord once again. Rents rise and fall on the basis of valuation taking into account similar properties in the area and data from big property companies. An increase in rent leads to a reduced yield meaning the capital value of the property increases. A reduction or stagnation in rent will reduce the capital value of a property. It is key to proactively manage estates to prevent reversion of interest or re-leasing of overvalued property down to market rent. Upwards only rent reviews can prevent this, however if the market rent is lower than expected a tenant may seek means to break their lease and obtain another lease at the lower market rate. Equally a landlord may wish to dispose of a bad tenant in order to re-lease their property at a higher market rate. If a property is not generating income due to being unlettable, or due to rental and therefore capital values dropping in the area, an estates manager may wish to dispose of the property by selling it, or redeveloping it to attract new tenants.

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