Frictional costs of investing in property

KPMG Investment Advisory
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- **UK property is a long-term investment and property investors should recognise that investment can come with substantial frictional cost leakage.**
- **These costs are usually incurred via a bid-offer spread faced by investors on entry and exit of funds.**
- **Costs can vary by fund but are primarily driven by the relevant taxation, legal and other charges involved with executing the purchase or sale of the respective underlying physical property assets.**
- **While frictional costs are not a red flag for investment, they should be factored into the strategic decision.**

Frictional costs

Round trip frictional investment costs, (i.e. buying and subsequently selling units in a UK property fund), can vary by fund, but average 6-8% of capital invested.

This can be split to c.5-6% on investment into a typical property fund and c.1-2% on disinvestment, with costs usually applied to the price at which units are dealt.

Consequently, UK property should only be suitable for those with a long-term investment horizon. This is due to its illiquid nature, and the payback period, (the time taken to recover frictional costs), being longer than other traditional investments.

Cost breakdown

As noted above, investors will see a material upfront cost upon investment into a property fund. This is as a result of the difference between the offer price - the price at which an investor can purchase units - and the mid price – equivalent to the current net asset value of the underlying property assets and any remaining cash. Typically the offer price will be in the region of c.5-6% above the current mid price. An alternative to this seen in the market is a fixed charge for subscriptions (of a similar magnitude).

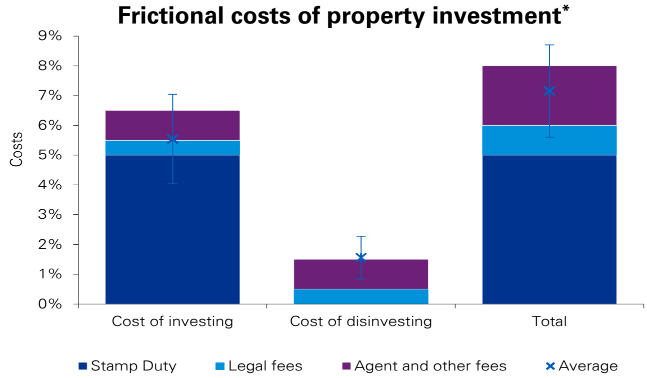
As an example, a £20m allocation into a pooled institutional unitised UK property fund will give you c.£19m of exposure on day one.

This is typically as a result of the units (and underlying assets) being valued at the current mid price, whilst you as the investor have had to purchase units at the higher offer price to protect current investors in the fund. The fund will need to accumulate a sufficient cash allocation from new investors and reinvested income to finance its next acquisition.

Similarly on exit of an investment, with a £20m holding, you would only receive c.£19.5m by application of the bid price to redeem units.

The chart below indicates the range of spread costs experienced when investing and disinvesting across a range of managers which KPMG surveyed in the market.

Frictional costs of property investment*



Note: Bar heights are estimates based on manager responses. Averages are based on managers surveyed during 2018.

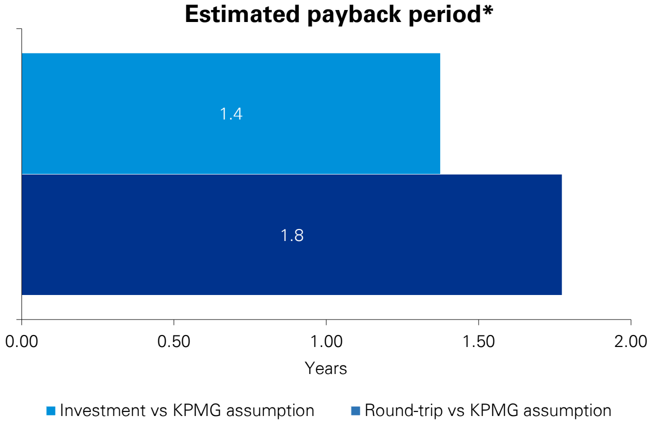
Anticipated payback period

The payback period can be viewed as the time taken to recover the initial or total (investment and subsequent disinvestment) frictional costs of investing in property, and is illustrated in the chart overleaf.

Nevertheless, we believe that while investors should be aware of the frictional costs associated with property investment and factor these into strategic investment decisions, they are not a red flag for the asset class.

> **Property is an illiquid asset class by nature and should only be allocated to with that in mind.**

*Source: Seven investment managers surveyed during 2018.



Factors which may impact the frictional costs

In surveying managers for this paper, KPMG professionals have sought to analyse the reasons behind the differences in spread costs.

Size of individual assets

Stamp duty must be paid to the UK Government on the purchase of all commercial and residential property in the UK. The rate of stamp duty applied increases as the value of the property increases, but for the size of most assets purchased by large institutional property funds the top bracket rate will be applied to the majority of the asset value (5% on the value over £250k, for non-residential commercial property). Consequently the stamp duty payable per asset will be at a set rate on the purchase price, although some managers may use special purpose vehicles to reduce the stamp duty burden to the fund.

Portfolio turnover

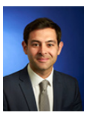
For each asset purchase and sale, there are associated legal and agent fees. Funds which decide to turnover the portfolio more regularly, or have a higher number of smaller individual assets, will incur higher legal and agent fees in the process of acquiring or selling each one.

With each purchase the fund will face stamp duty at c.5% (on the majority of the asset value), agents fees at c.1% and legal fees at c.0.5%. With each sale, just the agents fees at c.1% and legal fees at c.0.5%. Dependent on the complexity of the transaction and time taken to acquire the asset, the legal and agent fees can vary. A higher number of transactions undertaken will increase your payback period.

For more information please contact:

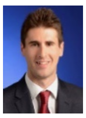
Stuart Pawson

T: 0121 232 3502
E: Stuart.Pawson@KPMG.co.uk



Andrew Singh

T: 0131 451 7749
E: Andrew.Singh@kpmg.co.uk



Simon Richards

T: 020 7311 2289
E: Simon.Richards2@kpmg.co.uk

*Source: Seven investment managers surveyed during 2018.

How are the costs impacted by market conditions?

The frictional costs of investing into or redeeming from an open-ended unitised fund are not directly impacted by market conditions.

However, in stressed markets a manager of a traditional open-ended unitised fund may ‘gate’ the fund (i.e. suspend dealing until market conditions improve) to protect incumbent investors from ‘fire-sales’ of assets at low prices. Alternatively, they may allow some investors to redeem units at a price significantly below NAV. This would provide the fund an opportunity to realise assets in order to meet investors’ liquidity needs without negatively impacting the value to other investors.

It is important to review fund documentation and be aware of the costs a manager has, and options a manager can take under stressed market conditions, as this can differ between funds.

Other considerations

This paper has focussed on the primary market for buying and selling units of institutional UK property funds, which can provide certainty of acquisition or redemption (but at a cost). An option which may help reduce some of these costs is by investment or disinvestment on the secondary market, either through a broker or via a manager’s internally matched book.

The frictional costs of investing in property are just one characteristic of the asset class. Another consideration is the time that it takes to put capital to work, or to disinvest from a fund. On some funds we research, we are seeing investor queues of up to 2 years to be able to invest. As well as potentially reducing the frictional costs of an investment, the secondary market may also provide a route to investing in or disinvesting from the asset class, quicker than achievable directly.

> **KPMG Investment Advisory team comment:**
> While property can be a great addition to a portfolio, be aware of the associated frictional costs and factor these in to your strategic investment decisions.
>
> It is important to review fund documentation and be cognisant of the costs and options a manager can take under stressed market conditions, as this can differ between funds.

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