Commercial property
Not for the faint-hearted

With the official cash rate at record lows, residential growth sluggish and eighty per cent of 2019's *NBR Rich List* Top 20 having made their money in bricks and mortar, many clients are looking seriously toward commercial property as a place to invest.

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Photos by Simone Hutsch on Unsplash

Commercial property may look attractive now, but those who remember boarded and empty shops following the 2008 recession will understandably be hesitant. So, before you dive headfirst into unchartered territory, it pays to know what to look for and be aware of the risks.

What are my options?

There are many choices when it comes to commercial property, but it starts with deciding what kind of commercial property best suits your needs. The main choices in New Zealand are industrial, retail and office.

Industrial

Real estate used for industrial purposes and includes warehouses, factories, and distribution centres.

Retail

Presents a broad range of options and includes shops and restaurants from single occupancy buildings right the way through to large shopping malls

Office

Office buildings range from small buildings in the suburbs right the way through to skyscrapers in the central business district

The quality of each category varies widely, and this has a significant effect on the ability to attract quality long-term tenants.

What are the most important things to consider?

There are three primary considerations when you are looking to buy commercial property:

Tenants

The person, organisation or organisations that occupy your land and/or property. It is worth considering whether they are a stable, long-term business that can service the rental payments without difficulty, and are happy that the property suits their current and future needs.

Yield

The expected annual return as a percentage of the property's value. This is often dependent on the quality of the property and location.

Location

Where the property is situated, including city/suburb, access to transport, markets and zoning.

What should I look out for?

Leasehold

Land values go up; building values go down. If you can't participate in the value of land increasing because it is leasehold, this removes a major attraction of property investment, and you are at the mercy of the landowner increasing lease costs. Our advice would be to avoid buying on leasehold land.

Developments

Future local plans can have very positive outcomes if a new development is planned with ample transport and auxiliary services, but if your new building is in a town that is about to be by-passed by a new highway, you will be very grateful that you invested in some due diligence.

Building quality

In general, what you are looking for is that a property that is at least a 67% NBS (New Building Standard). Specific things to look for include asbestos, earthquake-prone buildings and historic protections. While an old building can provide great opportunities for a change of use, they can also cause a significant hole in your pocket when changes cannot be made because they are historically protected or need to be vacated for costly earthquake protection. At present earthquake strengthening costs are non-deductible for tax, although this is under review. The tax treatment of other repairs or upgrades will depend on the extent of the work.

Hidden annual costs

Most leases are net, leaving the cost of rates, services and maintenance in the hands of the lessee. However, this is not true for all locations and cases. An example of this is Wellington, where some leases are gross leases, which leases include insurance, rates maintenance and other costs, which adds a high cost for the owner compared with other locations.

Potential

Some buildings may have the opportunity of changing their use to increase returns by being refurbished or going through a new fit-out. While this is a cost, a payback calculation should be performed to see if it is worthwhile in the long run. This may be based on being able to increase the rent to the existing tenant or acknowledging that new tenants will be needed to better match the new building function or higher specifications.

Tenant quality

For an acquisition that includes an existing tenant, it pays to include an assessment of your current tenant's business future and any red flags that could cause damage to property that cannot be recovered. Commercial leases are longer in duration than residential property, and when taking on new tenants, due diligence is important in protecting your investment, including at acquisition time.

What should I look for in the existing tenancy agreement?

Key considerations include:

- The length of the lease.
- Outgoings for building maintenance should be covered by the lessee.
- Regularity of rent reviews.
- A CPI (Consumers Price Index) clause in the rent review.
- A ratchet clause – even if the current rental is assessed to be higher than the market rent, the rent payable cannot go below either the current rent (hard rachet) or the value at the commencement or lease renewal date (soft rachet).
- A make good clause at the end of the lease.

What return should I be making?

Your yield should be above the interest rate both on any money borrowed and where your money could be otherwise invested. The yield on commercial property has been declining over time, although the recent slowdown in property price increases is likely to reverse this.

Commercial property is not for the faint-hearted and, as with all investments, a diversified portfolio is important to preserving your wealth. You may not have a large amount to invest, be unwilling to take the risk of investing in one property or want to avoid the stress of managing your own property investment. A less risky approach worth considering is investing in the listed commercial property stocks, which spreads the risk and are easily realisable.

If you would like to know more about commercial property investment options, check out the article *Listed Property Trusts and Syndicated Property* in the Winter 2017 issue of *Numbers*.

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