EXPEDIO
INDUSTRIAL PROPERTY

A GUIDE TO BUYING COMMERCIAL AND INDUSTRIAL PROPERTY IN NEW ZEALAND

BUYING CONSIDERATIONS

While most owners and investors probably have a fair understanding of the residential property market, buying into the commercial or industrial property market can be somewhat more daunting.

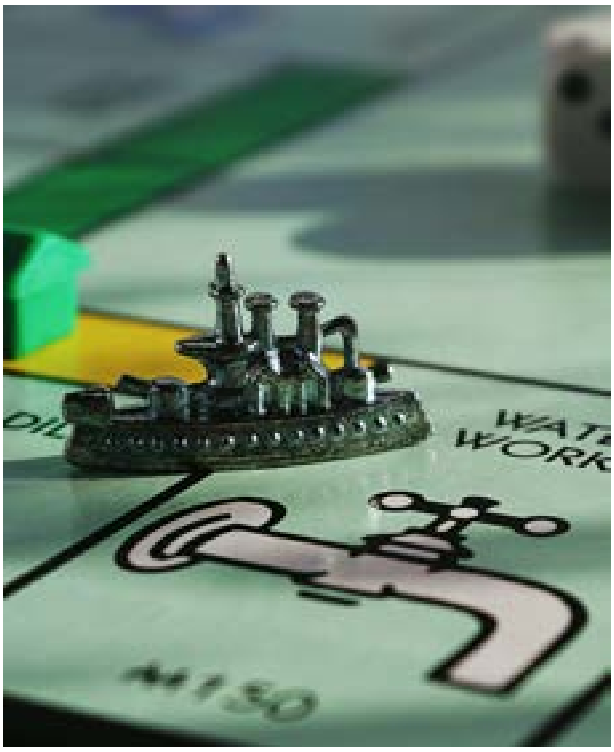
However, buyers who are prepared to spend time researching the market and carefully selecting an appropriate property can enjoy capital gains and, if you are an investor, solid cashflow.

There are two main reasons you might be looking to buy commercial property – as premises for your business or as an investment. While both groups of buyers will be looking for a property that is in the right location and has the potential to appreciate in value, the motivations and key buying criteria are likely to be quite different.

For the business owner, the key consideration will be finding a commercial property that suits the requirements and specific circumstances of your business, such as location, features and size. Your business premises may need to be close to key infrastructure, major suppliers or customers. It may need to accommodate specific pieces of equipment. If the business is in expansion mode, the property may need to offer room to grow.

However, if you are purchasing the property as an investor, you are likely to be more focussed on the possible return to be earned on the property. Considerations include the property being vacant or tenanted; if tenanted: the quality of the tenant, the stability and length of the lease, the rent the property is achieving and the likely cashflow the property will generate in any year, and if the property is vacant, how easy it will be to rent, and likely rental rates. An investor may be less concerned with the precise location of the property and may also be prepared to look at different types of commercial properties.

TYPES OF COMMERCIAL PROPERTY



While residential property has two basic types – houses and units/apartments – the commercial property market can be divided into approx 20 different categories once you dig down into specific areas.

The main commercial property types:

» Office – Office property ranges from multi-story towers in a central business district through to single level office buildings in the suburbs. CBD office buildings are typically categorised as being “prime” or “secondary” depending on their location, age and capacity.

» Retail – A category that covers a wide range of properties, from major shopping centres through to suburban strip shops.

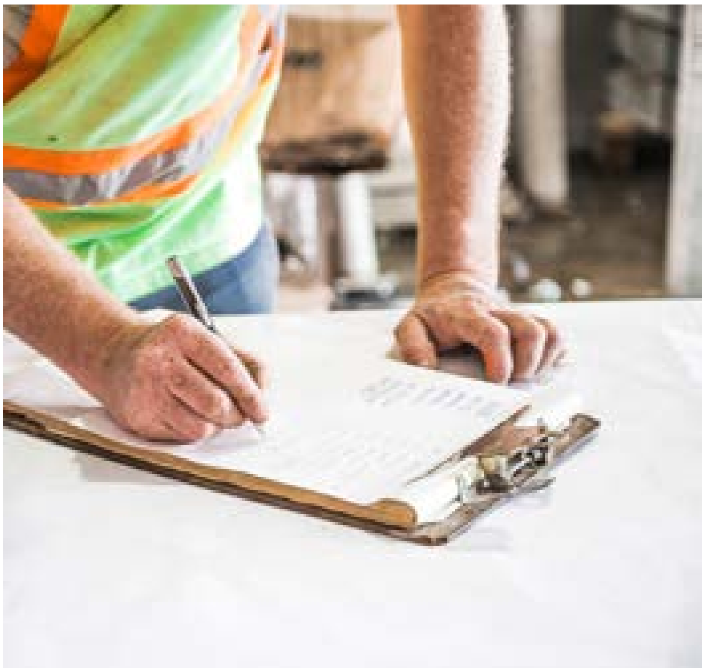
» Industrial – This category can include factories, warehouses and business parks. As with office properties, individual properties are typically categorised as being “prime” or “secondary” depending on their size and location.

» Infrastructure – Privately owned pieces of infrastructure such as ports, rail, waste management facilities and road infrastructure can fall under the broad category of commercial property, although most opportunities in these areas will be beyond the scope of the first time investor.

An individual property could span a number of these it in what is commonly known as a mixed-use property. For example, it’s common to see developments that include office and retail tenancies. Factories and warehouses typically have office space as a part of the mix.

WHAT TO LOOK FOR

Regardless of why you are buying, there are a few key items every buyer should examine and understand.



Yield (also called cap. rate): This is the most common word you will hear when discussing commercial property and it is the yardstick by which all commercial property investments are measured. Basic commercial property yield is calculated by taking the income from a property in a single year (that is, rent exclusive of operating costs) and dividing by the purchase price of the property.

For example, if a retail property was delivering rent of $70,000 a year and the property was purchased for $1 million, the yield would be 7%.

Remember that if a property is not tenanted, any yield is a potential yield only, and you may need to factor in the costs of tenanting the property. Typically these might include some refit, potential inducements such as rent holidays and of course you need to factor in how many months the property may stand empty.

Rent – The actual cash generated by a commercial property is crucial – strong cashflow is important, particularly if you plan to use the cash generated by the property to help finance a loan on the property.

Capital gains – Regardless of whether you are a business owner or an investor, you want the property you buy to appreciate in value over the long term. Capital growth rates will vary from sector to sector, from year to year and from region to region, depending on the prevailing economic backdrop.

$$\text{Income} \div \text{Purchase Price} = \%\ \text{Yield}$$

THE RISKS

Investing in commercial property is not without risk and buyers need to go into any purchase with their eyes wide open. Some of the key risks include:

Cost of entry: Commercial property generally has a much higher cost of entry than residential property, so buyers will need to be sure that they have their finances well planned and, if possible, equity in other assets to act as safety net.

Maintenance costs: While property outgoings (such as rates, utilities, insurance and body corporate fees) are the responsibility of the tenant, owners are responsible for maintaining and improving the property. This can be expensive, particularly when it comes to complex mechanical systems such as air conditioning and lifts. If you are an owner-occupier, all maintenance costs plus operating costs fall on you and this will be an additional cost (as opposed to leasing a building).

Location risks. While the construction of a motorway near your property may help lift values, not every new nearby development will be beneficial. For example, the construction of a new shopping centre near an existing retail development may push rents down or push tenants away from your property.

Tenant risks. If you are buying a commercial property as an investment, the stability and quality of your tenants will be crucial. Having multiple tenants might lessen the risk of having a single tenant who cannot or does not pay the rent, but it can also mean more work managing various renewal periods and tenant requirements. Finding tenants can also be much harder in the commercial market than in the residential market, and you need to consider this if you purchase a building vacant, or with a tenant on a short lease. Tenants may require costly renovations, at your cost, in order to take on a lease.

There are also a few specific risks to buyers purchasing a property to house their business:

CAPITAL RISK: buying a commercial property to house your business can tie up capital that might be better employed for other purposes, such as funding expansion opportunities.

BUSINESS RISK If your business starts to struggle, the pressure of maintaining and meeting loan repayments on your commercial property may weigh you down.

GROWTH RISK. If you outgrow a commercial premises you own, moving can be a very expensive business. Furthermore, if your business requires a specific location and type of building or facilities, it may be difficult to lease once you cease to occupy it.

RESEARCHING THE MARKET

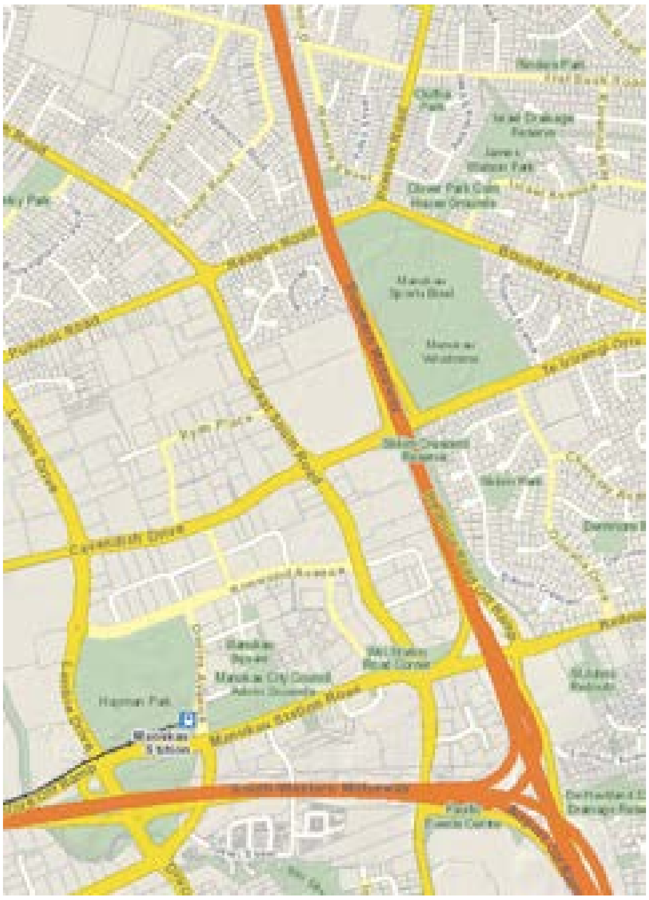
Like any investment, a commercial property purchase needs to be carefully researched. For property, this research can be done at three levels – a market-wide level, a location level and an individual property level.

At the market level, there are a number of factors to take into consideration:

- Economic growth. Demand for commercial property is directly related to the performance of the economy – when growth is rising, businesses will be growing and looking for new premises as they expand. Look at long term forecasts and focus on the specific areas (for example a specific city, or even a segment of a city) where you are looking to invest.
- Interest rates. Perhaps the most important piece of economic data to monitor is interest rates, which will affect property valuations, tenant demand, yield, and most importantly, financing costs.
- Employment data. Over the long term, employment data has been shown to be a good proxy for commercial property demand.
- Vacancy rates. The vacancy rate for commercial property in your chosen market – that is, the proportion of properties that are currently not leased – is another important measure of demand at a point in time.
- Recent transactions. Commercial property buyers should monitor sales results and reports of leasing deals to get a feel for market trends.
- Industry specific research. Major real estate companies, banks and economic forecasting firms regularly produce research on the performance of the commercial property sector and it's various sub sectors
- Other investment returns. If you are buying a commercial property as an investor, it's crucial to keep an eye on investment returns from other asset classes, such as shares, residential property and fixed interest. If commercial property returns are unfavourable when compared to these other asset classes, investors may want to treat with extra caution.

RESEARCHING THE LOCATION

Once you feel confident that you've researched the market thoroughly and it is the right time to buy a commercial property, it's the time to start researching locations with more focus.



Factors to consider when reviewing locations for a property include:

» Demographics of the area. Demographic trends that might impact your commercial property purchase include population growth, employment, housing structure and even the age of the residents in the area.

» Business profile. What businesses can be found around the location? Heavy industry? Retail facilities? Business or office parks? All of these could impact demand for your property.

» Infrastructure. The proximity of the business to key transport infrastructure (ports, rail depots or road infrastructure) is always important, but will be particularly so if you are buying the commercial property to use as your business premises.

» Amenities. The proximity of a commercial property to amenities such as shopping centers and public transport can have a great impact on its attractiveness to tenants.

» Planning or regulatory changes. Potential planning changes can have a big impact on the future value of your product. For example, plans for a new motorway could mean your business becomes much more attractive to tenants. However, the building of new developments in your area could create the problem of oversupply.

» Zoning. Council zoning can impact on the type of business which can occupy your property.

RESEARCHING THE PROPERTY

You've picked the right location, you've zeroed in on what looks like the perfect property – now it's time for some serious due diligence. There is a long list of items that you will need to check, including:

» Condition of building and need for repairs or maintenance. The age of the building may help indicate what sort of maintenance may be needed soon.

» Site access, including disabled access

» Condition of utility services (water, sewerage, power)

» Parking and vehicle access. Is there enough parking for all employees? If it's retail, is there customer parking?

» Access to public transport

» Land and building measurements, and zoning

» If the building is mixed use, the proportion of space for each use is important to consider. For example, many older buildings (mixed factory/warehouse and office) have much more office space than would be used, or put into a new building today

» Distance to amenities (particularly food)

» Environmental issues (for example, site pollution due to previous uses of the site - asbestos is beciming an increasingly important issue)

» Condition of heating/cooling systems/lifts/roller doors

» Susceptability to earthquake damage (usually known as IEP)

» Condition of grounds

» State of floor coverings

» Fire suppression & alarm equipment

» Opportunities to expand or sub lease space

Bringing in experts to assist with the inspection of any of these items may be required, depending on your personal level of expertise.

The other major area of due diligence is on tenant arrangements. Buyers need to carefully scrutinise the contracts in place with tenants, paying close attention to the length of leases, terms and conditions and renewal deals. Lease agreements can be lengthy and complex, so getting expert assistance is essential.

EXPERT HELP

Buying commercial property is not a simple process and first time buyers should try and get as much help as they can.

As in the residential market, buyer's agents can assist investors and owner occupiers with the process of researching and selecting an appropriate property for a buyers budget. Specialist commercial real estate agents can also help guide you through the buying process. As with every profession, there are good and bad agents – so ask for referrals.

A lawyer with experience in commercial property is essential for a buyer of any experience level. A lawyer will be able to examine contracts for purchase and look over leases.

An accountant could also provide valuable advice, particularly for business owners who wish to use the property as their premises and may need help modelling the financial impact of property ownership on the broader business. An accountant will also be able to advise a buyer on the tax implications of their purchase.

Buyers will also need to seek the help of a bank or finance company representative specialising in commercial property, should they need additional finance.

The best advice though, is to research the industry and the property thoroughly. There is no substitute for having enough understanding personally to be able to make an informed decision, rather than relying on advisors.