Commercial real estate and the endless quest for yield

By John Jack

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Returns (or yields) determine the value of a commercial property, with the general rule of thumb being the lower the price of purchase in relation to the rental, the higher the yield.


John Jack, CEO of Galetti Corporate Real Estate

Simply put, the yield is calculated by taking your annual net rental income received from the property and dividing it by the amount invested. Depending on your investment objectives, one needs to consider short-term cash flow or long-term capital growth.

Adding to this, capital growth rates in commercial real estate are predicted to be relatively low in comparison to previous years, therefore yields are a key factor in determining whether to invest and what the return on investment will be, total return is the sum of yield plus capital growth, with less capital growth expected one would anticipate higher yield requirements.

Now, in one of the most economically and socially calamitous years yet, we are seeing lower yields than ever.

However, Jack makes a point of noting that the yield spread between long and short-term leases makes for a peculiar landscape across the commercial, industrial, and retail property sectors.

Investors are paying a premium for long-terms leases in excess of 10 years which will help to minimise the impact of negative reversions in the short-term; on the other hand, shorter leases under five years are 'oversold' with an easy 300-basis point spread between that and a 10-year lease. Historically this would have been closer to 100-basis points.


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Long-term leases as a safety net

According to Jack, most landlords would prefer to ride out the rental reversion storm by securing a long-term tenant.

While short-term rentals in the commercial space are proving popular and can be profitable, they present greater risks for landlords and investors. Investors are looking for income security in the long-term. In exchange for lower yields, there's lowered risk, improved cash flow profile and income security.

Up until the beginning of 2020, a favourable yield for a long-term lease was around 9%. However, lately we are seeing bids in the region of 7.25% for long-term leases which is a combination of risk off demand and a low interest rate environment.

The rise in short-term leases and increased sub-letting activity places further pressure on an already strained market. Sub-letting is also proving to be major competition for landlords where tenants are often able to undercut an existing landlords' best proposal.

At a time such as this, rental incentives are the answer to securing long-term leases. While in the past finding a five to ten-year tenant was possible, right now, no one is willing to overcommit.

ABOUT THE AUTHOR

John Jack, CEO of Galetti Corporate Real Estate