Considering commercial

By John Roberts

7 Nov 2013

Investing in property has always been about location, whether the purchase is commercial, industrial or residential. However, getting value from the estate agent or broker and, thus, securing the best return on investment, means also knowing and asking the right questions - and pushing to get the answers, particularly if that means digging for information akin to seeking out diamonds.

Commercial real estate investments include office buildings, strip malls, restaurants and any other real estate in or on which people can conduct business. Among them is found single-unit main street buildings in small towns to skyscrapers in urban settings and landlords usually charge rentals based on the square metre of space rented.

That calculation is substantially higher than residential rentals on houses or apartments.

Investors seeking a commercial property investment must principally establish the rental income that can be received from that property as well as the lease terms and conditions, namely the expiry date, annual escalation rate and the strength of the tenants currently holding those leases.

The expenses on the property

Following closely behind are questions relating to the expenses on the property, because only then can potential investors establish a market-related purchase price as well as the cap rate at which they become prepared to sign on the dotted line. If the property is part of a shopping centre, having a cup of coffee in that centre to observe the foot traffic may be the first step in getting a handle on the potential investment.

The next question that needs raising is zoning. Often the records reflect that the property is zoned for business, but the owner has failed to pay over the transportation development levy to the municipality. Consequently, avoiding that pitfall means buyers should state in their deeds of sale that any outstanding transportation development levies become the seller's responsibility.

They also need to examine the municipal plans and surveyor general's diagrams of the property to ensure there are no servitudes, while lease agreements have to be scrutinised to ensure the details provided are correct.

Prospective developments

Due consideration also needs to be given to prospective developments within the area. If an airport is going to be built within the vicinity and the building under consideration houses a spa and outdoor café, the value will likely decrease because of the noise from the new airport. However, if the building has the potential for warehousing and logistics, its location close to the airport could prove to be the x-factor in its value.

Many commercial buildings are leased sometimes to more than one party. Potential buyers should ask their broker for a rent roll and copies of the current leases, particularly if the purchase is for a building with multiple store fronts.

The rent roll reflects the lessees; how much rent they pay; whether they contribute to the common area expenses; what the lease terms are and when they expire. Also included is information on rental increases with commercial leases usually spelling out the increases either linked to the consumer price index (CPI) or as a set percentage.

However, determining a realistic return on investment is difficult and depends on the strength of the tenant occupying the property, the location (that word again) and the length of the lease. A rule of thumb is a 10% return on investment, but there are always variations.

Part of the variation can be attributed to the building grading. A-grade buildings are generally those less than 10 years old; B-grade ones would be between 10 and 20 years and C-grade buildings are over 20 years old.

However, upgrading a C-grade building could raise the rental levels to being roughly in the bracket typical of a B+ grade one, while allowing a B-grade building to deteriorate could cost the owner in terms of rentals tenants are prepared to pay.

Generally, A-grade industrial premises command rentals of R45 to R55/m2; B-grade industrial premises are in the region of R25 to R35/m2 and C-grade between R15 and R20/m2, but every one of these rates will depend on the yard availability to the specific units, so these become further key questions potential investors should enquire from the broker.

The RoI

However, one key benefit to owning commercial property, particularly as an investment vehicle, remains the return on investment. Typically these investments are paid off more swiftly than residential property investments - in a decade rather than 20 years - and the commercial property market is more stable than the homeownership one. Leases are based on longer periods: three, five or 10 years at a time, with steady escalations.

Purchasing a property in the right position offers investors good returns for years and once the property is bond-free and fully tenanted, it also places the owner in a position to acquire an additional commercial property through leveraging.

ABOUT JOHN ROBERTS

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