

Earthquake Strengthening My Building



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Your Valuation and Property Specialists

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 - ❖ Murray Lauchlan
 - ❖ Ian Wallace
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About Duke & Cooke, focussing on the Commercial Team

D&C staff present today are:

- Dick Bennison
- Barry Rowe
- Ian Wallace
- Shaun Poole

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Presenter: Murray Lauchlan

- ❖ Registered Valuer
- ❖ Nelson 27 years
- ❖ Director of Duke & Cooke
- ❖ Heads the Commercial Team
- ❖ Specialises in:
 - Portfolio valuations
 - Financial reporting
 - Leasehold
 - Motels



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What we've heard so far

- ❖ NCC – the compliance police driven by the Building Act
- ❖ Opus – the seismic go-to people
- ❖ AON – the bearers of bad news trying to save your dollars
- ❖ Duke & Cooke - ?

What have we heard so far?

1. **We've heard from the NCC how they and the TDC** are driven by the Building Act and each have their required **Policy on Dangerous, Insanitary and Earthquake-prone Buildings**. We have learnt from them where they are at in the process of screening buildings and have heard where owner's responsibilities lie.
2. **Opus** have told us how they can assist property owners to first understand their buildings level of compliance with BA standards and then advance this process through the technical aspects of design solutions for seismic strengthening.
3. **AON** are at the coal face of insurance risk management and are largely takers of what the insurers are now proposing by way of premiums and policy changes. They are however in a great position to ensure you have the most appropriate cover and identify ways in which your insurance costs can be minimised.
4. **It is my intention** to advise on how all these changes may impact on your property investment value and to give you a brief insight into what you may see going forward.

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Commercial Property Valuation 101

Property values are driven by:

- ❖ Net Cashflow (NCF)
- ❖ Investment Returns (IR%)
- ❖ Deferred Maintenance (DM)
- ❖ Simple Formula



$(NCF / IR\%) \text{ less } DM = \text{Market Value}$

$\$40k \text{ pa} / 8\% = \$500k - \$50k = \$450k$

So welcome to your course “**Commercial Property Valuation 101**”

Simplistically, and with few exceptions, market value is driven by Net Cashflow; Investment Returns required by investors; and an allowance for any Deferred Maintenance items.

1. **Net Cashflow** is the cashflow from rental income after allowing for non-recoverable Landlord expenses
2. **Investment Return** is the investment return required by the investor
3. **Deferred Maintenance** is any outstanding or required maintenance to bring a building up to an acceptable standard for leasing or Building Act compliance
4. **Explain formula** to derive Market Value

Let's look at these formula inputs a little more closely and see what drives them

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Cashflow

Cashflow can be impacted in two ways:

- ❖ Market Rentals changing – why?
- ❖ Outgoings increasing – whew, that doesn't effect me because my tenant pays the Outgoings!

Cashflow impacts can occur as a result of either changing rental levels or property costs and, no matter how you look at it, it is the property owner who will eventually take the outcome, which may be positive or negative.

- 1. Rental levels will fall for EPB's if** tenants perceive them to carry a greater physical risk of occupation – that may come from a desire to protect their customers or be forced by staff unwilling to occupy such buildings.
- 2. Rental levels will also fall if** the add-on costs of occupation to a tenant i.e. rates, insurance and Building Act compliance rise excessively. Tenants consider the total cost of property occupancy (i.e. base rent plus outgoings) and will choose the building offering the cheaper total cost of occupation.

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Investment Returns

What factors would influence an investor to pay a premium or discount an investment property's value?

- ❖ Security of lease
- ❖ Status of tenant
- ❖ Location
- ❖ Rental being above or below market
- ❖ Risk



The commercial property market is dynamic, so what influences an investor to pay more or less for a property? It really is a bit of a juggling act, but critical considerations would include:

1. Security of lease – it's all about term certain
2. Status of tenant – blue chip or fly by night
3. Location – as per Bob Jones' mantra – it's all about Location, Location, Location
4. Rental above or below market – implies a future gain or loss
5. Risk can come in many forms, such as specialisation of design; market trends (on-line shopping); changing design standards (green buildings or seismic strengthening)

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Deferred Maintenance

Right now I have to spend money on this property to bring it up to standard!

- ❖ Fees
- ❖ Interruption to cashflow
- ❖ Costs of strengthening \$\$\$?
- ❖ Management



Deferred Maintenance includes all work that needs to be undertaken on a building to bring it up to an acceptable standard for occupation. These items could include structural maintenance or seismic strengthening.

Having established a need for seismic strengthening of a building the possible effects on cashflow will be:

- **Fees** – i.e. structural design and council
- **Interruption to cashflow** – perhaps your tenant has to vacate during strengthening
- **Costs of strengthening** - have I budgeted enough - contingency fund – some buildings uneconomic to strengthen
- **Management** - time and effort

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Recap on Commercial Property Valuation 101

In simple terms, if as a result of a building's age or structural integrity cashflow is diminished or a higher level of investment return is demanded ...

Market Value will be affected

To recap

Market value is driven by net cashflow, investment return and deferred maintenance.

Therefore if net cashflow decreases or if investment return increases or if a need for structural maintenance arises then a fall in property values will follow.

It's as simple as that.

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What are some of the lessons
being learnt from Christchurch?

- ❖ Leasing terms and conditions
- ❖ Insurance issues
- ❖ Heritage buildings

Christchurch has awoken NZ'ers to the real risks of living in a seismically active country. Lessons have been learnt and situations have arisen that have caused a lot of head scratching and close reading of leasing terms and conditions relating to “untenantable” premises. So what are some of those early lessons?

1. **Lesson #1 - the ADLS form of lease** has been well adopted around NZ and Clauses 26 and 27 of this lease deal with situations of full or partial Damage or Destruction of leased premises.

Simply put, where a building is rendered “untenantable” then “the term shall at once terminate”

Sounds good – but what is untenantable?

Each case is judged on its merits according to: time taken to repair; unexpired lease term; what area of the building is damaged; degree of permanence.

It is an interesting fact that denial of use and access, or lack of utilities, is insufficient to render a building untenantable

If the building is not untenantable then the tenant's obligations to pay rent continues.

2. **Lesson #2 – Insurance Issues**

Loss of Rents cover for 12 months or less is appearing to be inadequate

Demolition cover in a natural disaster is a problem

Insurance Excesses for some buildings have increased significantly in the case of a Natural Disaster

Insurers are now addressing Technical Risk - building construction (age and materials) and sub-surface ground conditions

3. **Lesson #3 - Heritage Buildings are nice to have** but there must be a balance between public safety and the cost of preservation

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What might we see going forward?

- ❖ Rental Levels
- ❖ Transactions

What changes in the market place might we see in the future?

Rental levels over the last four years have been static to falling since the onset of the GFC in 2008 and struggling to get any forward momentum –cost increases can only worsen that situation and that will be even more evident in respect of older non-strengthened EPB's. Tenants themselves may become more selective in respect of buildings they will occupy based on safety and staffing concerns.

In the meantime the increasing costs of occupation may well be the catalyst that will result in more business failures.

Saleability and market value of non-strengthened EPB's will diminish. Some buildings will be uneconomic to strengthen and may even be non-insurable therefore making mortgage funding and selling a significant issue.

That concludes my presentation. Thank you for your time and patience.