

OUTLOOK

Investing in Commercial Property



Rhonda Muir
Rhonda Muir specialises in commercial property valuations in Richmond & Nelson CBD

The current global finance crisis has been contributed to by numerous finance companies funding secondary or marginal commercial property investments. Now is the time to get back to the fundamentals of sound commercial property investment.

THE FUNDAMENTALS

So how do you recognise a good commercial property from an average or bad one?

The key fundamentals to examine can be summarised as follows:

- Tenant Covenant
- The Lease
- The Building
- Wider Market Considerations
- Future Potential/Opportunities

TENANT COVENANT

A logical place to start is with the tenants. If the tenants are an established and reputable practice/company, they offer better security of future income than unknown, new or dodgy tenants. Do not hesitate to look up the Companies Register and carry out credit checks to find out more about the tenants.

Also important are the nature of the business that the tenant is in, its market and the life cycle of that business. For example, medical professions appear to be expanding at present both in number and size, creating good demand for premises which we believe may continue to grow in the near future. In contrast, demand for office space appears to be relatively stable after a period of softening demand.

One good tenant can be easier to manage than several smaller tenants, but the risk of having a vacant building at lease expiry, or earlier, can be lessened with multiple tenancies.

THE LEASE

If the tenant covenants meet your criteria, then it's time to closely examine the leases.

Most leases today are in the Auckland District Law Society (ADLS) format. This is a relatively equitable lease whereby the tenant is responsible for the payment of the base rent, plus all outgoings relating to the operation and fair wear and tear on the property, excluding structural repairs and maintenance. Rent reviews are usually at two- or three-year intervals and are subject to a ratchet clause whereby the rent cannot be reviewed downward below the commencement date rental.

Close examination of the documentation is required to establish the following essential investment criteria:

Lease Term

The longer the lease term, the better the security of income (subject to the tenant's ability to continue to pay the rent).

Rights of Renewal

Contrary to popular belief, the right to renew the lease does not add value to the property, as this is a right which may be exercised solely at the discretion of the Lessee.

Rent Review Frequency

Generally speaking, in times of rental growth, Landlords benefit from shorter/more frequent rent reviews; while in times of nil or negative rental growth, longer rent reviews are better for the Landlord.

Net or Gross Lease?

Standard ADLS leases are 'Net' because the tenant is responsible for paying the contract rent net of outgoings payments. However, some older leases still exist whereby the contract rent includes outgoings. These are called 'Gross Leases' and the Landlord must then pay the outgoings from the rent received from the Tenant.

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The Outgoings Schedule

It is not uncommon to see Clause 3 of an ADLS lease modified, so that the Landlord becomes responsible for the payment of the items that have been deleted. A full list of outgoings means the tenant pays for each of the items listed.

Ratchet Clause

A ratchet clause is a clause that prevents the rent from being reviewed downward from the current contract rent. Watch for leases in which this clause has been deleted or amended. In some instances, this clause will state that rent may not be less than the rent at the date of lease commencement, rather than the current contract rent.

Critical Dates

Note should be taken of the critical dates for rent reviews, notices, redecoration clauses, lease renewals and expiries. Obviously, the longer the term of the lease left to run until lease expiry the better. Also, it is more desirable to have rent reviews within one building staggered, so that rental growth is continual and prevents the tenants from joining forces against the Landlord in rent reviews.

Schedule of Chattels and Make Good Clauses

It is important to establish who owns what within a building. A list of the Lessee's chattels should be included in an attachment to the lease, as should the Lessor's items, particularly as additional rent may be applicable for various items. At the date of lease expiry, this clause also avoids confusion when the tenant goes to remove items in order to 'Make Good' the premises.

THE BUILDING

Important considerations in the building structure are:

Design

Generally speaking, the more specialised the building, the more difficult it will be to lease and on-sell once the tenant for whom it was built vacates. Even in non-specialised properties, architectural features or unusual layout, can create difficulty for fitting out space efficiently making normal rents too high for the premises.

Age and Construction

The Building Act 2004 sets out numerous requirements for building owners to comply with, in terms of Building Warrant of Fitness and Earthquake Prone Buildings (especially those erected pre-1976). Local Body Regulations may also add to the cost of owning and maintaining commercial buildings. Prospective purchasers should be aware of these acts and regulations.



Deferred Maintenance and Capital Expenditure

Deferred maintenance and future capital expenditure requirements should be identified so that the cost of such work can be deducted from the market value to arrive at a fair purchase price. This is a specialised area and the services of a Registered Builder or, for larger properties, a Building Engineer can sometimes be needed.

WIDER MARKET CONSIDERATIONS

Make enquiries regarding the supply and demand of similar buildings and accommodation. For example:

- What is the supply of vacant land nearby that could be developed for similar purposes? Are there any other proposed developments underway (or refurbishment work being undertaken) that could compete with the subject property for tenants in the future?
- What is the level of demand relative to the existing supply/stock?
- What is the trend in rental growth for the location and quality of space on offer?
- What are market capitalisation rates for similar properties in Nelson, and how does that compare for returns on similar properties in alternative locations?
- What are the prospects for economic growth in one region over another?

FUTURE POTENTIAL/OPPORTUNITIES

Money can also be made by looking for the hidden opportunities, such as potential to:

- Redevelop (if undercapitalised) or refurbish tired space
- Rezone the land to a higher and better use
- Subdivide the land
- Create Unit Titles

PITFALLS

Some of the pitfalls to watch out for include:

- Short-term or informal lease arrangements which may lead to vacancies in the near future
- Unfavourable amendments/variations to the standard ADLS Lease format
- Over rented properties, meaning limited potential for rental growth at the next rent review or possibly even longer
- Seismic strengthening or other major costs that have not been clearly quantified
- Land contamination
- Advice from strangers

DUE DILIGENCE

In order to avoid as many pitfalls as possible, conduct a comprehensive due diligence process before committing to

purchase. This should include:

- A comprehensive review of all tenants and leases, with further legal opinion if required
- Full list of chattels, fixtures and fittings
- List of operating expenses, with details of all existing building and service contracts
- Any current litigation, arbitration or disputes
- As-built plans for the building and fitouts, with a Building or Engineer's Report and their comments on any deferred maintenance or capital expenditure requirements
- Copies of local authority notices/requirements, LIM Report and rating assessment
- A registered valuer's report

CONCLUSION

Remember, property yields are a reflection of many different and varied factors, but mostly relating to risk profile and comparison with other investment options. At the low-risk end, comparison can be made with low growth but highly secure Government Bonds; and at the high-risk end with returns from highly specialised use or speculative developments.

Keep these key fundamentals in mind, and some good opportunities may even emerge from the current global turmoil!

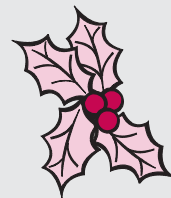
STAFF SNIPPETS

Lauren Bowden joined the Admin team on 1 December 2008.

Wendy travelled to Northland in mid November to compete in the 2008 Kerikeri Half Marathon.

Tina and her husband Andy became New Zealand Citizens on 30 October 2008.

CHRISTMAS & NEW YEAR OFFICE CLOSURE



Our office will be closed from **Wednesday 24 December 2008** and will reopen on **Monday 5 January 2009**.

We wish all our clients and friends a very happy **christmas and prosperous New Year**



Trudy Barnett
Graduate Valuer



Dick Bennison
Dick Bennison is a rural specialist in valuation, farm management and consultancy across the region.

Sheep Industry in Turmoil

HISTORY OF THE SHEEP INDUSTRY

The NZ sheep industry has been in turmoil for some time, and the downward spiral has never quite stopped since the 1987 International Share Market Crash. For years sheep farmers have been battling rising costs both on and off the farm with diminishing returns for prime lambs. The industry is in a crisis with the average sheep farm returns being below breakeven for the last three years. Rising land values are the only real driver keeping farmers afloat at this point. Is this sustainable long term?

The cold hard facts of the NZ sheep industry are this. The total sheep flock has declined significantly since the peak of approximately 70 million sheep in 1982-83. Now in 2008 there are just under half that number with only approximately 34 million sheep. That is an annual decline of 1.36 million sheep every year since 1983. If you compare that to the world population growth and increased food consumption since 1983, you could well wonder why one of the country's most important export industries is in decline.

NZ lamb is processed by a range of companies who pay the farmer according to the weight and the meat composition of the carcass. The price paid is established weekly according to demand, the NZ dollar, processing capacity and the supply levels available. This means the weekly meat schedule can fluctuate quite significantly throughout the season. The companies who process the meat then market and export the products. However, there is no allegiance between the processors to market the product in a co-ordinated manner, so they are constantly competing against each other for the best market price. Consequently, the markets can simply play one processor off against the other with the farmer having no control or input into this process. The vicious cycle continues: farmers get paid less and as a result they opt out of the industry in favour of other agricultural ventures with better returns; less lamb gets processed; fewer people are employed at processing plants, and still there is no marketing unity amongst the processors. Something needs to be done.

CURRENT STATUS OF THE INDUSTRY

NZ has a multitude of lamb processing companies located all around the country. The two largest are Silver Fern Farms

(formerly PPCS) and the Alliance Group. Both are farmer-owned co-operatives. These two co-operatives along with the other processors have their own structures and systems, and all individually market NZ lamb to a series of overseas buyers. The main market for New Zealand lamb is the European Union countries, which take 51% of New Zealand's export volume and is subject to a tariff-free quota of approximately 227,000 tonnes carcass weight equivalent (cwe). The balance of our supply goes to the United States, parts of the Middle East and some Asian countries. However, with the production of lamb predicted to drop for the coming 2008/09 season due to a series of droughts throughout the country over the last two years and declining international lamb production, farmers are anticipating a higher return from lamb. This is largely due to the reduction in supply of lamb combined with the increased demand for all meats, amid soaring world food price inflation. This is good news for sheep farmers; however, these returns will need to be sustained over a number of seasons to reverse the declining trend of sheep numbers.

The single most destructive factor of the NZ lamb industry is the way it markets its product to the world. The industry does not follow the supply chain through from the paddock to someone's plate in a foreign country. Instead it is sold to European processors who source, prepare and package the meat for EU supermarkets. The European processors take an estimated 35% of the profit margin, the EU supermarkets take a further estimated 35%, leaving only 30% of the profit to be shared amongst the shipping companies, processors and lastly the farmer. Surely there is an opportunity for the New Zealand processor to take that role and to retain more of the profit on shore through appropriate supply chain management.

The marketing woes of the industry are further compounded by extensive over capacity and inefficient, outdated processing plants that are failing to keep up with the latest technology and demands from both the producers and consumers. It is estimated that the cost of the necessary plant closures and redundancies required to address this problem could run to as much as \$400 million.

Reform of the method of payment to producers to reward those that meet the tight quality and weight requirements of the retailers is also needed. Processing companies have operated

on the same procurement system for a long time and they have failed to provide farmers with adequate information and feedback of what the market demands of the product. Producers are simply paid on the basis of carcass weight and fat composition of the animal according to the schedule with no incentive to produce higher-quality carcasses. If producers received detailed information on each carcass and were rewarded for producing what the markets wants, they could breed animals that would meet market demands. This would enable processors to customise payments according to the market yield of individual carcasses.

WHERE TO FROM HERE?

Radical changes are not necessarily required to get the NZ sheep industry back on its feet and improve the economic performance of the industry as a whole. It is clear that monopolies, no matter what industry they are in, have never been immortal, and the sheep industry is the same. Even if there was a merger of the two major lamb producers in NZ that control the majority of the market, they could never satisfy all producers, and smaller co-operatives would re-emerge under a new brand. In a utopian sheep industry the processors would have one marketing body that control the integrity of the product and what markets the product goes to, making the middle man superfluous. However, producers may never be able to have total control over the marketing

end of the supply chain, but what they can do is control what happens to their product before it leaves the farm gate.

There are a number of simple steps producers can adopt such as putting more ewes to terminal sires at mating time to produce faster-growing, higher-yielding lambs that kill out at an average of \$2.50 more per head than the maternal breeds. Choosing to use predominantly terminal sires would require farmers to better manage their ewe replacement rates and improve maternal sire stock. Finally, if farmers adopted proactive culling policies of their aging ewes, they could improve both lamb productivity and management efficiency through having the healthier stock in prime condition producing more prime offspring.

To conclude, there can be no doubt that widespread reform is required in the sheep meat industry for it to be sustainable in the long term. This reform is going to require major change in the way all parties in the industry think, and the solutions are more than likely going to be well outside the square of conventional thinking. Furthermore, significant capital will be required to firstly address the overcapacity and inefficient processing facilities, and secondly to develop appropriate marketing regimes. None of this will be achieved by rearranging the deck chairs. It can only be achieved by introducing new blood and brains into the industry, focusing on what the market wants and not simply on what has always been produced in the past.



Predicted Housing Shortage - Fact or Fiction?



Barry A. Rowe
Barry Rowe specialises in smallholdings and residential properties.

On Thursday 16 October, both The Press and The Nelson Mail contained articles about a predicted housing shortage that may be felt in 12 months' time. We have completed our own research to gauge how the local market will cope.

We have analysed the supply-and-demand factors within Nelson and Richmond as we believe if there is to be a housing shortage it will initially first be felt in these main areas. In addition, it is also where the most accurate and reliable data is available.

Historically, demand for housing is measured by the number of building consents issued for new home construction. We have analysed the building consents issued by both Nelson City Council and Tasman District Council from 2005. These are summarised as follows:

Building Consents Issued

	2005	2006	2007	2008
Tasman District Council	58	75	62	53
Nelson City Council	194	224	313	232
Total	252	299	375	*285

* Year to Date (excludes November & December)

The above totals show that there has been a significant increase in the number of new homes being built in Nelson city. The increase from 2005 to 2007 represents more than a 60% jump. The current year-to-date figure also looks as if it will exceed the 2006 total.

For the supply side of the equation, we have assessed the number of sections available, analysing those sections available on the market now and those that will be available in the future. We have summarised the availability of sections grouping the subdivisions into suburban areas.

Section Availability 2008

Sections Available	Atawhai	City	Stoke	Richmond	Total
Now	26	33	36	75	170
12 - 24 Months	26	35	20	129	210

We are also aware of a number of other subdivisions still in the planning stage that are not included in our figures. Surveyors and resource management consultants have indicated that for some developments clients are getting all the required consent planning approvals in place before starting the expensive earthworks stage, and the intention is to proceed once there is an improvement in the market conditions currently being experienced.

The building industry has a huge impact on the local economy. From the initial concept stage to final completion, building a new home will involve a minimum of 22 different businesses, regardless of whether clients decide to do as much as possible themselves, or get a complete house-and-section package deal. Larger projects

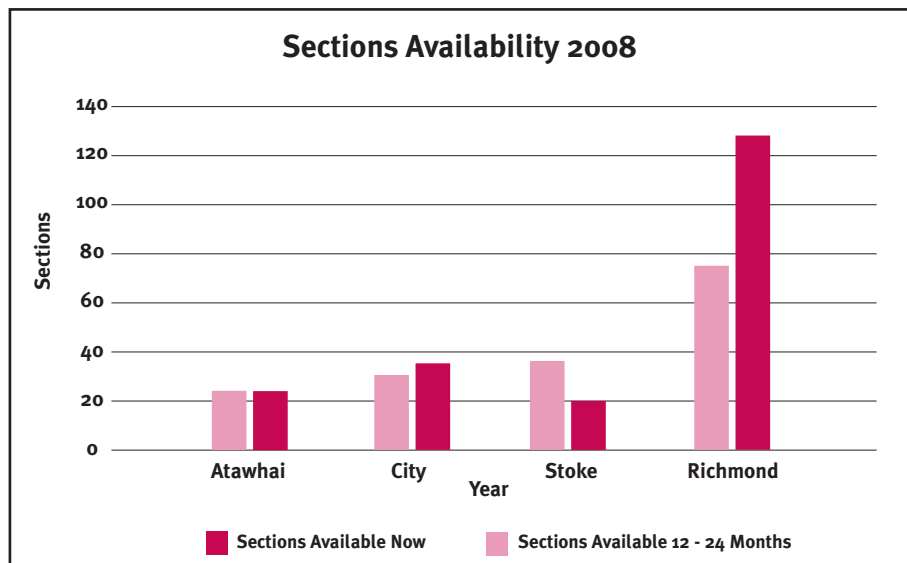
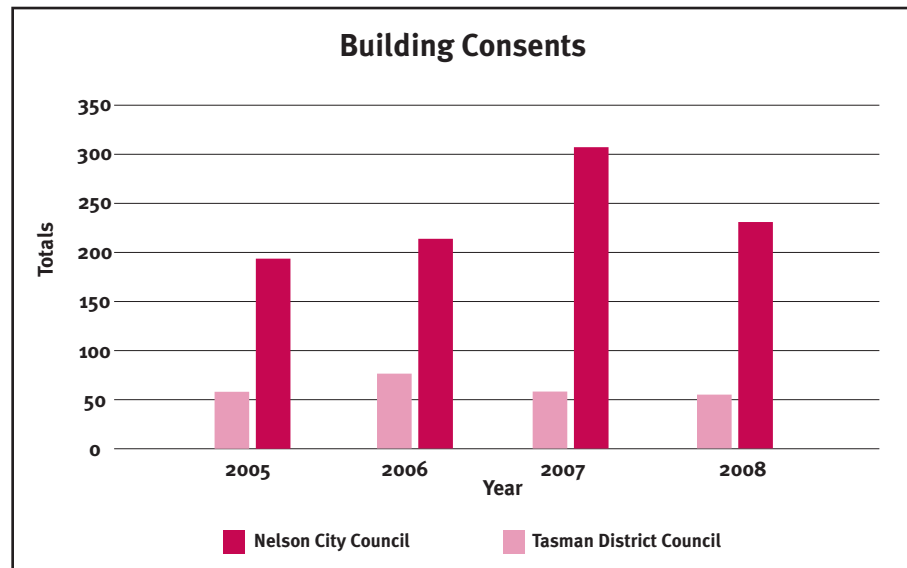
will directly involve another eight business, and these numbers do not include associated professionals such as legal, finance, insurance, real estate and valuation. Consequently, any slowdown in residential construction would be felt throughout the local economy.

Our research has been specifically based on the past demand for housing in Nelson and Richmond. On that basis it appears that the Richmond housing market is well placed for any possible housing shortage. It has a surplus of sections available in comparison to the numbers of recently built new homes. However the same can't be said

for Nelson. As indicated these tables, Nelson appears to be heading for a shortage of sections. In 2007 there were 313 new homes built and 232 for the year to date. Currently there are 95 sections available for sale with another 81 becoming available in the next 12 – 24 months, making a total of 176 – well short of the new homes built in 2007, and for this year so far. As a consequence fewer homes will be built in Nelson and a greater number constructed in Richmond as this is where sections are available.

However, future demand may differ from what we have previously experienced. Census predictions indicate

that the populations of both Nelson city and the Tasman district will continue to grow, with the latest figures for Nelson city being 44,700, and 46,500 for the Tasman region, which indicate annual increases to July of 0.6% and 0.7% respectively, significantly slower than the increase the region experienced in 2003, when it was 3%. However, as the region continues to grow an increasing population will require housing whether they decide to rent or own, and so pressure will continue on the existing housing stock and developing future subdivisions will be essential.



NZ Emissions Trading System is Live



Ian Wallace
Graduate Valuer

Following on from our article "Forestry, Carbon Credits and Maybe Even Profit" in our first Outlook article of the year, the New Zealand Emissions Trading Scheme (ETS) is now live and affects all forest owners. The Climate Change Response Amendment Act 2008 received the Royal Assent on 25 September 2008.

As of 1 January 2008, post-1989 forest land started to earn NZUs¹ for net increases in carbon stocks and pre-1990 forests were liable for any deforestation. Some key dates are worth noting:

PRE-1990 FOREST LANDOWNERS

31 January 2009

If you have deforested between 1 January 2008 and 31 December 2008, you have until this date to notify MAF of this deforestation.

31 December 2008

If you wish to deforest after this date, you will be required to notify MAF within 20 working days of commencing deforestation.

30 June 2009

If you wish to exempt up to 50 hectares from this scheme, you must make application to do so by this date. This exemption will allow you to fell these areas without having to pay back a deforestation liability based on the value of carbon units the forest would have at maturity.

31 July 2009

If you wish to receive NZUs for your forest, you need to apply for allocations by this date. You can apply on-line.

August 2009

A draft determination of units you may be allocated for your forest will be released by this date, and you will have until October 2009 to object to any errors.

December 2009 and April 2010

Allocated NZUs will be transferred to you.

31 March 2010

Deadline for forest owners who deforested during 2008 or

2009 to file an emissions return for the 2008 and 2009 calendar years detailing their deforestation liabilities.

30 April 2010

Deadline to surrender units by forest owners who deforested during 2008 or 2009.

POST 1989 FOREST LANDOWNERS

1 January 2009

Registered forest land owners may voluntarily file an emissions return for the 2008 calendar year using a Look-Up Table approach².

31 March 2009

Deadline for registered forest land owners to voluntarily file an emissions return for the 2008 calendar year.

31 March each year

Deadline for registered forest land owners to voluntarily file an emissions return for the previous calendar year.

31 March 2013

Deadline for registered forest land owners to file a mandatory emissions return for the five-year period 1 January 2008 to 31 December 2012. This return will take into account any emission returns filed earlier during the five-year period and any credits issued as a result of those returns.

In relation to indigenous forests, the legislation specifies that indigenous forests established before 1 January 1990 are not included in the ETS. Owners of these forests have no liabilities under the ETS, even if they deforest. Equally, they are not entitled to an allocation of NZUs.

Post-1989 forest land includes indigenous forests.

A very good source of more detailed information on sustainable forestry and the ETS is provided by MAF at <http://www.maf.govt.nz/sustainable-forestry>

¹ One NZU (New Zealand Unit) = one tonne of carbon dioxide/CO₂

² Look-Up Tables approach: pre-determined values for carbon stocks by age and regime using well-established growth modelling techniques



REGISTERED VALUERS. PROPERTY,
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