Buyers' guide to commercial property opportunities

Investors looking to switch from the cooling residential market must first change their mindset, writes Larry Schlesinger.

Investors need to consider the physical layout of the building, its location and its proximity to other commercial properties. **Luis Enrique**

by **Larry Schlesinger**

When retired Adelaide doctor Prabhash Goel paid almost $11 million for a Bunnings warehouse in the Victorian town of Swan Hill, his reasoning was simple: "The Bunnings lease is one of the best around for commercial properties."

What he got was a 12-year lease to the Wesfarmers-owned DIY retailer, which will pay him more than $600,000 a year, with fixed annual rent increases and all costs covered – a true "set and forget" investment.

While the deal was struck on a record-low yield for a Bunnings of 5.1 per cent, it's still better than most residential investments, where after-cost returns rarely touch 3 per cent.
"It's the second Bunnings I've bought for our family [last year he bought the Bunnings property in Ballina for $21.3 million] and I will buy more," Goel says. "They are a stable tenant and their lease conditions are fair."

Standing room only at a Burgess Rawson portfolio auction in Melbourne. **Pat Scala**

Goel, who acquired the Bunnings warehouse in Swan Hill at a packed Burgess Rawson auction in August, is part of a growing pool of investors looking to add commercial property to their investment portfolios as the heat comes out of the housing market.

WHERE SHOULD YOU BUY?

According to Burgess Rawson director Dean Venturato, retail property backed by long leases (five or more years) to blue-chip tenants, especially the likes of Coles and Woolworths, will again be sought after in 2016, but investors should be prepared to pay more for these assets and accept a lower return.

Fast-food outlets, bank branches, service stations, childcare centres, government-leased property and supermarkets were the most popular assets in 2015 and will continue to be the most desired in 2016 because of the usually strong lease covenants and trophy-asset appeal of owning a Bunnings, Coles or Woolies supermarket, Westpac branch or Hungry Jack's.

Prabhash Goel says the Bunnings lease is the best in commercial property **Pat Scala**

But there are good opportunities in the office sector too, says Alex Henderson, managing director at Sydney-based buyer's agents and asset manager Prosper Group.

Henderson says there is high demand from his investor base for freestanding office blocks in the suburbs, as well as for medical centres.

Both offered the potential for strong capital gains through future rezoning to residential, while being solid income-generating assets, yielding about 5 per cent. "Even in the bad times, medical centres perform well," Henderson says. "If they trade well, they are almost as good as buying a Coles or a Woolworths."

For those sticking to retail property, Fred Nucara, director of Melbourne-based Beller Real Estate, says investors should look at opportunities at shopping strips where apartment development is also under way.

"High-density development creates a customer base for tenants," he says. "If you want to get ahead of the game, you could look at areas where projects are mooted."

KNOW YOUR TENANT

If you're looking outside the major retail brands, it's important to get an understanding of your prospective tenant's business and whether it's profitable, so you know they have the ability to pay their rent. "Make sure you do your due diligence," Nucara says.

It also pays to keep abreast of wider changes in the market. For example, if you are thinking of investing in retail property, you should consider whether the tenant will be affected by the rise of online shopping.

Video stores, newsagents and corner milk stores are all becoming redundant, according to CBRE leasing agent Zelman Ainsworth. By contrast, food businesses and boutique fashion retailers that are creating a buzz through social media are doing well, he says.

But a word of warning on blue-chip investments – investing in a supermarket backed by a 20-year lease to Coles or Woolworths may seem sound, says Prosper director Damien Holliday, but the price-return ratio often overrides the fundamentals.

"The turnover rent [the agreed percentage of rent paid based on annual turnover] can be set so high that it's never achieved or the rental agreement does not cover all outgoings, meaning your net rent essentially goes down over time."

EVALUATE THE INVESTMENT

While most people are drawn to commercial property because of the higher yield, Nucara says taking a one-dimensional view and just thinking about the tenant is fraught with danger.

He says investors should also consider the physical layout of the building, its location and its proximity to other commercial properties.

The physical layout is important if you are investing in properties like banks and fast-food outlets, which are often purpose-built, making it harder and potentially very costly to refit for a new type of tenant, Nucara says.

"There's also no point investing in a fashion store on a high street renowned for cafes and bars. Make sure you do your due diligence by chatting to selling agents to get an idea about the rental history of the property. Also, visit the neighbourhood and speak to neighbouring tenants."

When looking at a retail investments, consider the amount of frontage (the width of the store facing the road). For an office investment, the amount of parking is important.

Henderson says investors who don't have at least $1 million to spend are best served sticking to residential property because the risk is they will pay too much.

"At the lowest price points, it's very competitive between mum and dad investors, and you also have business operators who are snapping up their own premises."

The higher up the food chain you go, the better the opportunities. "We don't buy anything under $1 million because you have to make too many sacrifices in terms of the quality of the asset," Henderson says.

Prosper aims for a net return of between 5.5 per cent and 6.5 per cent in Sydney, slightly higher in Brisbane and Melbourne.

"If the yield is above 7 per cent in Sydney, there's generally something wrong with the property," Henderson says.

OPPORTUNITIES IN REGIONAL TOWNS

With yields tightening for the best commercial property in the capital cities, a noticeable trend in 2015 was the appetite among investors for property in regional towns, where yields can be higher and there may be less competition for assets.

"There's nothing wrong with buying in a regional town, provided there's good underlying fundamentals (population growth, strong economy, etc) and it's a good business in a good location," Nucara says.

But, he warns, capital growth won't be as strong as for inner-city properties. "The basic rule is that capital values double every seven to 10 years within 10 kilometres of the CBD. In regional, that's more like 12 to 13 years."

Investors should also bear in mind that in some regional hotspots, returns may not be much higher than in the major cities.

"We've sold a Hungry Jack's in Port Macquarie this year on a 5 per cent return – a couple of years ago that same property would have sold on a 7 per cent yield," Venturato says.

The red flags are regional towns dependent on one industry, where the risk of losing a tenant and not being able to replace them is greater, with mining towns the most obvious examples.

IT'S NOT THE SAME AS RESIDENTIAL

Investors looking to shift from residential to commercial property should bear in mind that it's an entirely different proposition.

On the positive side, returns are higher and leases are generally much longer than a residential lease – sometimes 10 or even 20 years, with built-in annual rent increases.

But if tenants do leave, properties tend to stay vacant for longer periods compared with residential property, so you need to have a financial buffer to cover these periods.

"It can be months between commercial tenants compared with a few weeks for residential property," Henderson says.

Also, while residential property can be bought with as little as 10 per cent equity, it's generally 30 per cent for commercial property.

Henderson says one area where investors come unstuck is not knowing the true return on their investment because commercial leases are much more complex. "They think they are getting 6 per cent, but when they factor in insurance, land tax and other costs, it's more like 5 per cent."

It's also important to adopt a long-term view and have the financial means to cope with a rise in interest rates.

"If rates go up, a lot of people will get into trouble," Goel says. "We have got other cash businesses, so we can sustain any interest rate rise, but I am not sure other investors can."