COMMERCIAL PROPERTY INVESTING

EXPLAINED SIMPLY

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Commercial Property Investing Explained Simply.
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STEVE PALISE

‘*Commercial Property Investing Explained Simply* fills a gap in the market; with so many books for residential investors, at last a comprehensive guide to commercial property by an undisputed expert in this area’.

Adrian Butera – MD, Compton Green Real Estate and winner of the Real Estate of Victoria Auctioneering Championships 1999, 2001, 2004 and 2010.

‘As somebody whose family has been around commercial property in Australia since 1956, Steve beautifully articulates the journey, but more importantly the OPPORTUNITY in diversifying your property portfolio, going commercial and elevating yourself to the next level.’

Andrew Morello – Winner of the first Australian *Apprentice* and Head of Business Development at The Entourage.

‘After researching many industry professionals, I found Steve to be the most knowledgeable, sensible and sincere. He has now purchased over $3.2 million worth of commercial property for me across multiple states of Australia – and we are looking for our next one!’

Cameron Rowe – Sailor for Royal Australian Navy (age 30).

‘Steve has helped many investors successfully invest in commercial property. Now he shares his expertise in this very readable, practical book.’

Grant Simpson – Founder of The Commercial Guys real estate agency.

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WHY COMMERCIAL PROPERTY?

> *'Commitment unlocks the doors of imagination, allows vision, and gives us the "right stuff" to turn our dreams into reality.'*
>
> —James Womack

In my work as a buyer's agent, whenever a client says they want to achieve a particular amount of passive income per year, I cheekily respond, 'And then what?'

A common first goal is to have $100,000 in passive income per year – and with commercial property, that's actually very achievable in a short period of time. But I find that people's answer to my question reveals the real driver behind their wealth creation. They usually want to spend more time with their children, to travel, to quit their job and work on something they're passionate about, or a combination of these.

So before you consider whether commercial property investing is right for you, it's important to decide what goals will make you happy. What motivates you? Assess your short-term, medium-term and long-term goals. I've spoken to thousands of people from different walks of life; some are over the moon when they can afford a new fishing reel, others when they can purchase a $250,000 sports car. Everyone's compass for happiness is different. Most people, however, overestimate what they need to achieve their happiness goals, and this means they take on unnecessary risk.

Be realistic with your goals, and don't just come up with a portfolio size or passive-income amount. Sacrificing time today for a specific number tomorrow may not be consistent with your personal values.

My own happiness comes from travelling, socialising, climbing mountains, feeling appreciated and working on passion projects. Property investing has enabled me to pursue these goals – I travelled, for example, to 30 countries by 30 years of age without sacrificing my professional career or my relationships. I'll never be someone with hundreds of properties in my portfolio, but I don't need to be, because my happiness doesn't depend on my numeric wealth – it's purely about choice and freedom.

My story

I'm now one of the most successful commercial buyer's agents in Australia, but I had humble beginnings in a gentrifying suburb of western Sydney. My father was a television repair technician, my mother was a stay-at-home mum and I have two older brothers (and even at 6 foot 3 inches tall, I'm by far the smallest of the bunch). We never felt poor, and were always cared for and looked after.

At high school, I finished in the top 1 per cent of the state, and at the time, thought academic excellence would equate to wealth – and that wealth would bring happiness. I had a natural affinity for mathematics and theoretical concepts that led me to study engineering at university, and I finished first in the course.

After university, life progressed well. I began to earn good money and became one of the youngest engineers in Australia to become chartered in both mechanical and structural engineering. My focal point has always been design, as in engineering it offers little room for subjectivity. It all comes down to the numbers! I had a vast array of design jobs, from designing medical equipment to designing mine sites.

Like many, though, I got caught up in the rat race. I was working long hours, earning a good salary and creating wealth, but I saw unqualified employees being promoted and earning high incomes while some of the most qualified employees were working hard but going unrewarded. My belief that academic excellence and hard work would be enough was shattered.

I decided that I didn't want my life as a professional to limit me, nor did I want to leave my financial future in the hands of a faceless corporate machine. So, I chose residential property as my path to financial independence. I spent countless hours reading every property-investing book I could get my hands on and speaking in depth with (and probably annoying) people in the industry who had 'made it'.

After three years of research, in 2012 I bought my first investment property in western Sydney for $230,000 – and saw it increase in value by $80,000 in one year. This was $20,000 more than my yearly salary at the time, and it was my light-bulb moment. I was hooked! Every year I purchased more properties, and my portfolio grew exponentially. Eventually, I bit the bullet, left my engineering career and went full-time into property. I became a buyer's agent and helped grow a buyer's agency into one of the largest in Australia.

Within a few years, I'd helped clients purchase more than 500 properties in the residential space. I was always fearful of commercial property though. Like everyone else, I'd heard that it was risky. I was told commercial properties did not achieve capital growth, had a high chance of vacancy and that, basically, commercial property investing was only for the wealthy. As I began to research, however, I quickly saw that it was all a misconception!

The returns on commercial property can be spectacular compared to residential property. And, as you'll see, you can mitigate almost all of the risk with thorough due diligence. For me, commercial property was the game changer, providing instant passive income and financial freedom.

The benefits of commercial property

Unless you plan to work your way up the corporate ladder to a very well-paid position, or to start a successful business or invent something, chances are you'll need to invest well to become wealthy.

I'm not trying to convince you that investing in commercial property is the best option for you, as investing in shares or residential property also has huge advantages if you know what you're doing. Still, in my view, commercial real estate can give you a financial freedom that other investments cannot.

However, if you're interested in shares or residential property, there are many blogs, magazines, newspapers and websites to keep you informed and make you a better-educated investor. There are very few resources for people interested in commercial real estate. I've now purchased hundreds of commercial properties for my clients, and have spoken with many accountants and mortgage brokers, and I constantly have to explain the benefits of commercial property and the misconceptions about it. This was what inspired me to write a summary of the key points to commercial investing, which after some intense labour, evolved into this book.

'Commercial property' can include any property that is held for the purpose of generating a return on investment. It comes in many forms, including industrial, retail and office, and some combination commercial and residential properties. All forms can be profitable investments, as you'll see. Long considered a more niche alternative to traditional investments, in recent years commercial real estate has started moving to the mainstream as a highly sought-after asset.

Some of the benefits of commercial property investing include:

- high cash flow returns
- stability of income
- low long-term risk
- exposure to different sectors of the economy
- tax benefits

- hedging against inflation
- investment control
- ability to add value
- leverage or financial gearing.

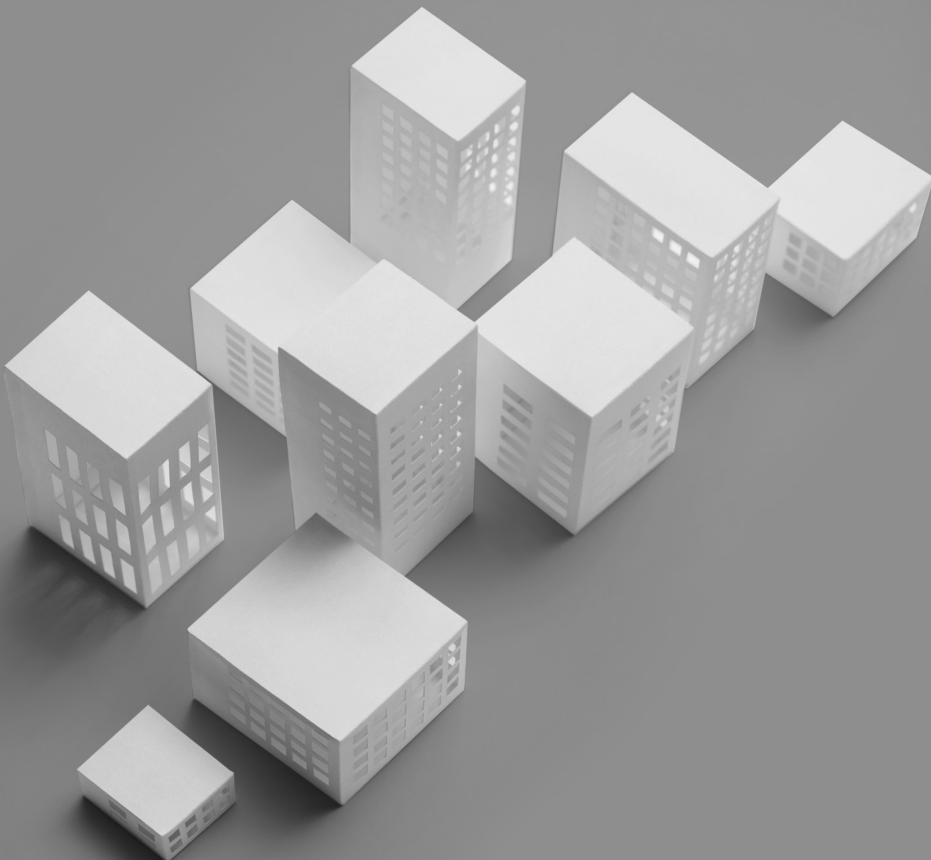
'Leveraging' is using debt rather than equity in one asset to buy another asset. This can allow you to make greater returns, but you can also lose more and end up in a negative position. People are scared of debt, yet even those who aren't wealthy take it on – for instance, in buying the family home. Leveraging to invest can seem scary, and there are lower-risk assets available, but commercial property offers a means to achieve big returns both in capital growth and cash flow, with minimal risk – if you know what you're doing.

It's imperative never to invest in something you don't understand – it's too risky, unless you seek reputable investment guidance. In this book, I'll educate you on the issues in commercial property investing and how to do it in a low-risk manner. I'll explain step by step how to analyse, select and buy commercial property, ensuring that the value of your investments will continually increase – so you end up making as much money as possible with as little risk as possible.

Note that I've written the book primarily for the Australian commercial property market, although many of the principles will apply worldwide.

Also, note that the strategies I outline here are designed for effective long-term investment. If you're looking for a get-rich-quick book on investing in commercial property, then this book probably isn't for you. However, if you want to understand how commercial property investing works and learn a tremendous amount of information you can apply, then read on! *Commercial Property Investing Explained Simply* will show you how to plan, find, analyse and build a profitable commercial property portfolio and avoid incorrect financial decisions. I hope you enjoy reading it and it opens your eyes!

PART I
RESIDENTIAL VERSUS COMMERCIAL PROPERTY



Property investors often debate whether to go residential or commercial. There are far more residential buyers than commercial, however, partly because those who favour residential property typically have little experience in commercial property. As everyone lives in some form of residential property, they feel they have a grasp of it, and it's considered a human necessity – although commercial properties do provide the resources and services necessary for our survival. There's also much more media coverage about people making money in the residential market, whereas commercial property is seldom spoken about.

About 70 per cent of residential property in Australia is owner-occupied, and so the owners have an emotional attachment to it. By comparison, commercial property is typically bought as an investment and purchased based on the numbers and return, even if it's going to be owner-occupied.

Most commercial purchases are valued based on their rental return. In the residential market, a property must increase in value for the buyer to make a profit, but commercial property can create wealth even without capital growth. A commercial property's rent is often also indexed to inflation, which means the market will rarely move away from you. In general, commercial net returns are much higher if you get it right, but can be riskier if you buy a bad property, as it could be vacant longer. If you buy a bad residential property in a good suburb, though, you'll generally be okay in the long term.

So, how can you decide whether commercial property investing is right for you? Let's look at some of the key differences between the two, in the table following. (Note that the figures given are indicative only – the exact numbers for a particular property will depend on factors like its location, type and versatility, and demand.)

	Residential property	Commercial property
Deposit required	10–20%	20–35%
Due diligence	Minimal	Comprehensive
Yields	3–6% gross average	5–8% net average
Leases	6–12 months	12 months – 30 years
Bonds	1 month	1–6 months and/or bank guarantee
Outgoings	Covered by owner	Covered by tenant
Repairs	Covered by owner	Covered by tenant
Depreciation	Average	Higher
Vacancy	1–2 weeks average	1 month – 2 years average
Cash flow	Negative to neutral	Highly cash flow positive
Loan interest rates	Variable over time	Generally 0.5–1% higher than residential
Capital growth	Market dependent	Market and rental increase dependent
Property management	Intensive	Low–medium effort
Value-adding	Renovations and developments (subdivision, townhouses, etc.)	More creative methods (ATMs, advertising space, etc.)

I'll go into detail about these differences in the relevant chapters later in this book, but here's a brief, general overview of each difference.

Deposits

For commercial property, you'll need a larger deposit than you do for residential. Lenders generally allow a loan to value ratio (LVR) of only 60 to 80 per cent for commercial property, whereas residential property lenders will allow LVRs of 80 to 90 per cent, or even 95 per cent. In other words, you'll need a 5 to 20 per cent deposit for a house or apartment, compared to a 20 to 40 per cent deposit for a commercial property.

So, the first perceived disadvantage of commercial property is that the cost to get into the market is high. However, in fact, the entry level for commercial property can be as low as $50,000 for something like a car park or regional office. Also, even in capital cities, industrial space can start at as little as $150,000. Another point that's often ignored is that the extra deposit required for commercial property is often recovered through cash flow alone within two years.

If your borrowing is dictated by the capital you hold, investing in commercial properties will mean you use less leverage, as they require a larger deposit and lower LVR. But if your main consideration is being able to service the loan, commercial property gives you finance options that residential does not. More on this in Part VI.

Due diligence

Once you've chosen the location for a residential purchase, the amount of due diligence required is quite small. It will typically involve a building inspection and a few checks on things such as whether the property is in a flood zone. If the area selected is of value, the property's worth will probably grow with the market.

Commercial properties, on the other hand, require an enormous amount of due diligence. You'll need to investigate and consider the asset type, the vacancy rate for that type of asset, the foot and road traffic around it, and conduct building inspections, a lease review, and a tenant review. Part V explains due diligence in detail.

Yields

Higher yields are the thing most often spoken about when it comes to commercial property. Residential property yields are gross yields, whereas commercial property yields are typically given as net yields. With residential property, the gross yields are typically between 3 and 6 per cent, and owning a residential property incurs considerable outgoings such as council rates, water rates, body corporate fees and maintenance. This can bring the net yield down to approximately 1 to 3 per cent after the outgoings.

Commercial properties, by comparison, will on average have a 5 to 8 per cent net yield. The reason it's referred to as a net yield is that the tenants will usually be responsible for 100 per cent of the outgoings. As you can see, with commercial property, you can receive a much greater multiplier of the net cash-flow return. This is one of the key reasons measured investors prefer to build a commercial property portfolio.

Chapter 6 has more information about yields.

Leases

There's a perception that commercial leases are more confusing than residential ones. In the past, this could be the case, as they were quite convoluted, but leases are now quite standard and much easier to read. Nonetheless, it's advisable to have a solicitor look over commercial leases, whereas with residential, it's enough for you and the property manager to check over leases.

Leases on both residential and commercial properties can be as little as month to month, however, residential leases are generally only 6 to 12 months, whereas commercial leases are from a year to 30 years long. In 1759, Arthur Guinness (founder of Guinness

Brewery) signed a lease on a brewery in Dublin for 9000 years! Residential tenants want the flexibility to be able to move should their circumstances change. Commercial tenants, by comparison, want the security of knowing they'll be able to remain at the location long term, as their business and livelihood depend on it. See Chapter 7 for more information.

Bonds

Residential properties usually have only a one-month bond, while commercial properties typically have a bond of one to six months. They can also have a bank guarantee for fulfilling the lease. A bank guarantee is a formal assurance by the tenant's bank that an amount of money will be paid to the landlord if the tenant does not fulfil their obligations under the lease agreement.

It's worth noting here that with residential property, the eviction process can take months and involves complicated legal proceedings. Evicting a commercial tenant is often much simpler with less red tape, as the property is not their home. More on bonds and guarantees in Chapter 7.

Outgoings

With residential properties, the owner is responsible for most costs, such as council and water rates, repairs and maintenance. With commercial property, the tenant is typically responsible for most if not all outgoings, which means a much higher cash-flow return for the owner. See Chapter 8 for further information.

Repairs

Residential tenants won't usually look after the property as if it were their own, which means more wear and tear and higher maintenance bills for the owner. Renovating a house can cost the owner tens of thousands of dollars, too – replacing old kitchens, bathrooms and carpet, for example, can get very expensive.

By comparison, in most cases, a commercial tenant is responsible for the property's internal fit-out and shopfront. The presentation of the property can be tied to their lease, too, so that the tenant is required to maintain it or risk breaching their lease and having it terminated. Commercial tenants will look after the premises generally though, because they've paid for the fit-out and pay the cost of maintenance. The condition and appearance of the property reflects on the business, meaning they're more likely to look after the premises in order to make a good impression on their customers.

They are also liable for the health and safety aspects of the property (staff and customer safety), and are likely to apply higher level of security features such as alarms, security guards and CCTV. The property will not be left unattended for a long period of time without your knowledge; whereas, for example, tenants of residential property may go overseas, leaving the property vacant and more vulnerable to intrusion, an uncontrolled fire and so on.

Depreciation

Unusually, for all real estate investment, including commercial, the depreciation is tax-deductible. No other asset class has this advantage. Depending on the age and style of the building, a commercial property will usually have higher depreciation due to the more expensive construction and fit-out, so this can be an advantage as higher depreciation means greater tax deductions for the owner. Chapter 9 goes into depreciation in more depth.

Vacancy

Vacancy rates are a significant point of difference between residential and commercial property. Residential properties in a well-chosen area will usually have a vacancy rate between one and four weeks per annum. There will generally be a higher turnover of tenants due to the shorter leases, as tenants may choose to move for work, because they've received a pay rise or lost their job, in order to buy a home or because their relationship status has changed.

Tenants of commercial properties, by contrast, are less likely to move because their livelihood is attached to the business, and they've paid for the fit-out. However, commercial properties in a high-demand region will typically have a vacancy rate of one to six months, and getting it wrong in commercial property can mean long periods of vacancy. With vacant properties, having the right marketing agent and the properties' rent priced correctly can assist in leasing the property more quickly.

Being able to afford the loan if your tenants move out is an important consideration here. Of course, this also applies to residential property, but with residential property, you will have shorter, more regular vacancies versus commercial, which will have longer vacancies less regularly.

People sometimes argue that commercial investment is riskier in terms of vacancy, but that's only true if you've bought a risky property – like buying the equivalent of a residential investment property in a mining town where rental demand is tied to the state of the resources sector. Even with a good commercial property, you still need a bigger cash buffer to cover aspects such as longer periods of vacancy, upgrades to the property or rental concessions (such as rent-free periods for tenant fit-out).

Cash flow

Most residential properties are negatively geared: you're losing cash flow in the hope that the capital growth will outweigh that loss. By buying this way, you might at some point have problems servicing the loan, and you'll also need to keep your job to be able to pay the mortgage. It is possible to find some good-quality neutrally geared or slightly cash-flow-positive residential properties, but even so, banks apply a serviceability criterion that will give your portfolio a negative cash flow in their eyes.

Commercial property has a high cash flow and servicing the loan is less of an issue, meaning that, as an investor, you can keep expanding your portfolio.

Take a look at these typical cash-flow examples for a residential property and a commercial property.

Residential property cash flow

Property: a house in the western suburbs of Sydney, bought for $780,000.

	Annual
Income	
Rent $500 p/w	$26,000
Expenses	
Loan interest (5% interest only, 80% loan)	$31,200
Council rates	$1,547
Water rates	$987
Building insurance	$1,200
Maintenance	$1,600
Property management	$1,400
Total	**$37,934**

For residential investment properties in Australia, the negative cash-flow position can be offset from the individual's income. If they're in the 37 per cent tax bracket, this would mean they get back $4,416 at tax time.

Pre-tax cash-flow position	–$11,934
Post-tax cash-flow position	–$7,518

Commercial property cash flow

Property: a warehouse in the western suburbs of Sydney, bought for $780,000 @ 7 per cent net yield.

Income	
Rent $1,050 p/w	$54,600
Expenses	
Loan interest (5% interest only, 70% loan)	$27,300
Total	**$27,300**

Ignoring the building, plant and equipment depreciation, and keeping the same 37 per cent tax bracket, the cash flow would be as follows:

Pre-tax cash flow	+$27,300
Post-tax cash flow	+$17,199

As you can see, the commercial property has a much higher cash flow for the same outlay as the residential property. It's worth noting again, however, that a higher deposit is required for a commercial property and this would affect the return on investment (ROI).

Chapter 11 contains more information and examples.

Loan interest rates

Commercial loans will generally have higher interest rates compared to residential loans. This will typically be around 0.5 to 1 per cent higher; however, this will completely depend on the type of loan, deposit amount, type of property and the risk. One of the reasons why commercial loans have a slightly higher interest rates is because they have a shorter loan term (e.g. amortised over 20 years instead of 30 years), which raises the monthly mortgage payments significantly. They also have a smaller secondary business market, so there is less competition between the lenders to provide a better rate.

In the last 20 years, interest rates have generally been under 10 per cent. Even though interest rates are much lower now, I have used an average of 5 per cent interest rates throughout this book for simplicity and conformity.

Capital growth

There's a myth that commercial properties don't grow in value at the same rate as residential. If this were the case, there would be a huge disparity in prices. It's just not true, though. Most commercial properties have shown at least the same growth as residential properties, though usually on a different cycle.

Residential property relies purely on capital growth to make a net return. In the property cash-flow example earlier, the house's value must grow at $7,518 a year just to break even. But the average capital growth rate of property in all capital cities in Australia over the past 30 years is about 5.3 per cent annually. For this property, this would equate to $41,440 capital growth in the first year and more each consecutive year due to compound growth.

Residential property is typically cyclical, with periods of high growth, low growth, no growth and even negative growth. A commercial property that is tenanted, by comparison, is more likely to have a steady income. The capital growth can also be cyclic, but it's of a different nature, which will be outlined in more detail in Chapter 12.

The growth in the price of most residential properties in Australia has meant that Australians' dreams of home ownership are slipping away as it becomes more unaffordable. For instance, in 1990, the median price of a house in Sydney was $194,000 and the average salary was $27,227. So at that time, the median house price was equivalent to 7.13 times the average salary. In 2019, by contrast, the median house price was $809,000 and the average salary was $65,500 – equating to a median house price of 12.35 times the average salary. It's arguable that residential prices in some regions may hit a ceiling due to unaffordability and the growth will slow, and so the historical growth of the past 30 years may not represent the future.

One point to note is that median household incomes have gone up because it's now much more common to have two working people in a household. This is one of the reasons most residential markets in Australia have grown so much.

As mentioned, residential property can have downturns, too, whereas commercial property with a solid tenant will typically remain at the same price or grow due to the annual increases in rent.

The perception is that there's a lack of growth in commercial property investment, but this is incorrect. If this were the case, you'd be able to buy in the commercial market much more cheaply than in the residential market. It's true that different commercial asset classes have different growth rates, but there's much more to it than that (read Chapter 12 for more). Investment in commercial properties is based more on mathematical algorithms than on market growth fundamentals. Residential property investment is based on the hope of growth.

Property management

Residential properties require considerable effort to manage, because the tenant is typically only responsible only for their electricity bill and council rates. The owner has to cover the cost of all other outgoings and maintenance. With commercial properties, the tenants are usually responsible for outgoings and maintenance, and so they require less work on the part of the owner. The tenants' livelihood depends on the property, too, as mentioned earlier, so they're more inclined to care for it. We'll look at property management in detail in Chapter 28.

Value-adding

Residential property investors often renovate, or buy larger blocks to then build granny flats or even subdivide the property. While these ventures can be profitable, that's usually the most value the investor can add.

Commercial property, as we'll discuss in Chapter 29, has the potential for many different kinds of development, according to the type of asset class purchased. The possibilities include changing the property's use; adding more tenancies; increasing the rent; creating new sources of revenue such as installing ATMs or solar power; or renting out parking, storage or advertising space; or adding mobile phone towers and repeaters. Commercial property is much more versatile.

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You can see from this overview that commercial property has both advantages and disadvantages for investors compared to residential. With careful choice of property and location, commercial investing has the potential to provide a great return to the right investor.

In Part II, we'll look at the types of property you might consider purchasing and how to select properties which will fit your investing goals.