Looming Impacts to Commercial Property Values

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When owning a commercial property, there are several considerations that potential buyers take into account. One important factor is the tenant covenant, which depends on the type of tenant, the reliability and stability of their business, the agreed frequency and process for rent reviews, the length of time until the lease expires (term certain), and any rights of renewal (which are advantageous for the tenant). Other considerations include fixtures and fittings, delineating what belongs to the property owner and what does not. However, the most significant of these considerations is the property's yield—specifically, how much net rent the property earns per year as a percentage of its purchase price. Increases in operating expenses (OPEX), particularly insurance and rates, will significantly impact yields and, in turn, negatively affect commercial property values.

Ballooning Insurance Premiums

Commercial property owners have been facing rising insurance premiums over the years, a trend that is global and can be traced to several factors. The economic impact of climate change is becoming more pronounced, with average claim costs on the rise. The pandemic has led to higher inflation and disrupted supply chains, making construction more expensive and time-consuming. These factors increase costs for insurance companies when they pay out claims. Additionally, insurance companies have become more cautious about where they provide coverage, especially in areas prone to earthquakes. They pay close attention to the materials used in buildings and any potential risks. There has been a rise in legal action, and defending these cases is becoming more expensive. In New Zealand, insurers are particularly focused on the risks associated with earthquake damage in regions like Wellington, reviewing their coverage limits and often sharing risks among themselves, which leads to delays and higher premiums. This affects both 'Material Damage' coverage, which deals with physical property damage, and 'Business Interruption' coverage, which compensates for lost income during repairs. After the recent storm events in New Zealand, flooding can now be added to the list.

Proposed Rate Increases

Closer to home, local Hawke's Bay councils are proposing substantial but unsurprising rate increases from July as they look to fund the staggering recovery costs from the damage caused by Cyclone Gabrielle. Hastings, which was hardest hit in the region in terms of damage, is proposing a 25% rates increase in its recently released draft Long Term Plan (LTP)—one of the highest in the country. Other proposed rate increases across Hawke's Bay starting July 1 include Napier City Council at 23.7%, CHB Council at 20%, HB Regional Council at 19.6% (this could be more as they have changed their rating system), and Wairoa District Council, which has yet to release its proposal.

Why does this affect property value?

Yield and property value share an inverse relationship: as yields increase, property values decrease, and vice versa. This correlation is primarily driven by the market's perception of the risk and reward associated with a particular investment. Investors typically demand higher yields for riskier assets. Factors such as location, economic conditions, market demand, asset type, and tenant quality can affect the perceived risk of a commercial property investment. Riskier assets, such as highly specialized assets or those with short lease terms, generally yield higher returns to compensate for the increased risk. Conversely, properties in stable, prime locations with long-term leases tend to offer lower yields due to their lower perceived risk. Furthermore, Capitalisation Rates (cap rates), commonly used in valuation, are directly related to yields. As yields increase, the cap rates rise, which then lowers the property's value. Investors often use cap rates as a benchmark to assess the relative attractiveness of different investment opportunities. Another contributor to the rise of cap rates are higher finance costs.

As a result of the significant OPEX increase, net rents/returns are being seriously eroded. Market rents in Hawke's Bay are traditionally analysed on a gross basis, from which the OPEX are deducted to arrive at the net rent/return. If the OPEX rises faster than the gross rent, the net rent gets eroded and will have a negative impact on the value.

HASTINGS
T 06 871 0074

NAPIER
T 06 835 1617

PO Box 232, Hastings 4156, New Zealand
valuers@williamsharvey.co.nz
www.williamsharvey.co.nz