LEASE OR OWN?

DESPITE EARLY, PANICKED COVID PREDICTIONS BUSINESSES ARE NOT ABANDONING COMMERCIAL PROPERTY - BUT THEY ARE TAKING A CLOSER LOOK AT WHAT THEY NEED AND WHERE THEY PUT THEIR CAPITAL.

SINCE NEW ZEALAND'S FIRST lockdown in 2020 there have been many predictions about the future of commercial real estate - particularly office space.

Those predictions were initially fairly negative, sounding a death knell for offices as employees seemed to move seamlessly to working from home in most sectors.

Now, with almost two years of pandemic disruption and perspective under the belts of business, it's clear those predicting the demise of the commercial market were premature.

What is changing, driven as much by the fiscal landscape as the pandemic, is how businesses are looking at the capital they have tied up in property assets, and the flexibility they require from landlords.

OCCUPIER REQUIREMENTS

Ongoing periods of COVID-fuelled disruption to occupancy in the past two years have not seen businesses give up their commercial leases en masse, but they have motivated businesses in all sectors to take a good look at what they really need in a workplace, and what it will take to make employees want to return to the office.

Bayleys' national director office leasing and advisory, Steve Rendall says amenity, location and security are the key factors corporates are looking for in their workspace.

"Companies have key characteristics they want to see in the office environment. They're asking what will encourage employees back in, as well as what will help drive the culture of the organisation, allowing for effective collaboration in line with modern ways of working," Rendall says.

That means in metropolitan areas, particularly Auckland, tenants want to be near transport hubs like Britomart and the ferry terminals, says Rendall. They also want amenity, with close proximity to bars, cafes, parks, gyms and, where possible, the waterfront.

As often happens when there's a dip in occupancy rates, there is a flight to quality, Rendall says. "The newer buildings with up-to-date facilities generally secure higher levels of demand. Then businesses will look at the proximity of those amenities that make the workplace somewhere employees actually want to leave their homes to be," he says.

At the premium end of the Auckland market Rendall reports an increase in demand for smaller high-quality spaces, with price points going up. These are essentially turn-key spaces leased by the likes of Alberts, Precinct and Robt. Jones Holdings, where services are set up and ready to go.

"We're talking 150 to 200sqm high-end suites where the tenant walks in, plugs in their computer and they're under way. They're premium buildings at premium rates, sometimes offered on shorter-term leases of maybe a year to two years instead of the traditional three-year minimum."

Outside of the premium market, Rendall adds that in some parts of central Auckland, further away from

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the waterfront and into southern parts of the CBD, there is an added demand for security, with businesses wanting to know their staff are safe entering and exiting the building. He predicts buildings in some of those areas may become harder to lease or may look to reposition to a different use.

Though there are high levels of interest at the premium end of the market, there are things owners of secondary commercial properties can do to make their spaces more desirable for tenants, Rendall says.

"Price is the obvious one. Lower rentals can make secondary or sub optimal buildings more appealing to tenants, though there are limits as to how much you can use price as a lever, because it can affect valuations and most landlords have debt to service," he says.

Another way to attract tenants in today's market is to have an attentive management team that is prepared to really look after tenants and meet their needs, he says.

"Be flexible in how you engage with tenants. If you're an experienced landlord you're much more likely to be able to handle repairs or alterations more cost-effectively and efficiently than the business owner. Being a landlord that can roll your sleeves up and get things done for your tenant builds trust and loyalty."

FLEXIBILITY IS KEY

What all this is adding up to is an increased demand for flexibility from commercial landlords, whether that is physical alterations to the building interior or to the terms and conditions of lease agreements.

Inside the buildings Rendall says tenants are looking for sophisticated open plan options that meet their changing needs. "They want collaborative and communal spaces, like a kitchen or a lunchroom but also flexible meeting spaces and collaborative group-focused spaces. What appeals to tenants is office environments that help people to work the way they want to work," he says.

In some sectors businesses are also looking for flexibility to expand, contract or even cancel space as projects come and go. A good example, says Rendall, is some of the alliances being set up around major infrastructure projects.

"Let's take the Auckland Harbour Bridge and cycleway extension as a hypothetical example. A group came together, spent a lot of money on preparing a bid, then the project fell over so there was no longer a need for that alliance.

"For those types of organisations, the ability to take up flexible space on shorter-term contracts is really advantageous, because their future is less certain," Rendall says.

Growth in other sectors such as corporate professional services and consulting is also driving a need for more short-term, flexible space.

In metropolitan areas particularly, this has seen the rise in popularity of co-working, flexible office spaces, such as Precinct Properties' Generator in Auckland and the Regus Spaces offering inside the new PWC tower at Commercial Bay.

Lloyd Budd, Bayleys' Auckland director commercial and industrial, says the demand for flexibility in lease agreements is not limited to office space.

"Any business that has just got a new contract, or lost a contract or even bought another business, is going to want flexibility in their lease agreements so they can find the right space as their business needs change.

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"Going forward, businesses are going to increasingly prefer leasing to owning, because of the cost of capital and because they'll want to focus on their core business."

He adds that there's been dissatisfaction among some businesses with their landlords through COVID, particularly from those who struggled to get rent relief, but most will still be leasing rather than buying.

"Some have expressed a desire for more control by owning their own building, but the reality is most of the businesses that make those noises won't have the capital required to purchase," Budd says.

In fact, the opposite scenario is playing out with some commercial operators looking free up capital by selling property and leasing it back.

SALES AND LEASEBACKS

Bayleys' national director commercial and industrial Ryan Johnson says many corporates can see the value of getting out of property and using that capital to strengthen their balance sheet and invest back into business growth.

"The sale and leaseback concept is being looked at by a number of corporates because the return on equity within the business has been more than 15 to 20 percent EBITDA," Johnson says. "Yields have compressed to around five percent so some of them are thinking it's better to recycle that capital out of the real estate and off the balance sheet, and invest it back into the growth of the business.

"We're probably seeing it more in the regions; Hamilton, Nelson, Hawke's Bay and Tauranga," he says. "Previously there was a price gap between property in the regions and Auckland. Now there is so much capital out there looking for real estate, that gap has tightened."

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The latest 6 Green Star-rated Mansons TCLM Limited office and retail development at 136 Fanshaw Street, Auckland offers excellent amenities and close proximity to transport hubs, retail, bars, cafes, parks and the waterfront.

WHAT LIES AHEAD?

Johnson believes 2022 is going to be an interesting year "just in terms of where the cost of debt lands".

"There can be a direct correlation to an increased cost of debt to capital rates and yields, but equally to counter that, we are seeing strong rental growth in industrial as that sector continues to reap the benefits of online, particularly in logistics and warehousing."

Inflation will also be a key driver in the commercial market in the coming months, Johnson says. "Compared to other asset classes such as cash in the bank or fixed interest, the impact of inflation is huge. It could run at 5.7 percent for the 2021 financial year, and it's forecast to be 4.5 percent for 2022. Those increases certainly benefit the rental aspects of leases if they're linked to CPI as opposed to money in the bank where the after tax real return could be a low as minus 3.5 percent."

"We have seen a few sale and leasebacks in the past 12 months, where customers seek to redistribute capital and it's possible potential future interest rate rises may contribute to more of these types of transactions."

The Goodman perspective

Goodman Group is a developer and manager of industrial logistics and warehousing in Auckland. Portfolio manager Evan Sanders breaks down the trends it is seeing play out.

"We have definitely experienced an increase in demand for leasing. Trends such as e-commerce and consumers demanding more convenience, have led to an increase in demand to lease well-located logistics facilities.

"That e-commerce growth, and the need for retail businesses to re-organise their supply chains as a result of the changes to consumer demand, are the major trends we are witnessing. More recently, global supply chain issues have driven the need for our customers to hold more stock, resulting in the need for the extra warehouse space.

"Given the structural shifts and these underlying trends, customers do tend to look for more flexibility in their lease arrangement. This may be through lease term, relocation options or expansion rights.

"On one hand we are seeing some customers looking for shorter lease terms to provide the desired growth flexibility but equally, more customers are investing large amounts of capital in their fit out so are seeking to commit to the site for a much longer term.

"For us having a large existing portfolio and development capabilities, mean we can look to relocate existing customers across the portfolio or provide design build solutions. Much of our recent leasing has been a function of organic growth with existing customers either relocating to larger sites or taking additional premises with us.

"We have seen a few sale and leasebacks in the past 12 months, where customers seek to redistribute capital and it's possible potential future interest rate rises may contribute to more of these types of transactions."