PART FIVE
IN A SERIES

Put on your developer's hat

Calculating the financial feasibility is crucial

By Genna Levitch, BDS

There are a number of variables that need to be taken into account when putting together a financial feasibility study for a building project.

The factors affecting these variables are quite complex. The commercial property market follows a cycle different to the residential property market. It is more of a 12-year cycle and is dominated by the CBD in each capital city. Developers attempt to time their building programs to come on-line during high demand, while tenants try to secure long term tenure while supply is high. Currently, retail is showing slow growth due to a lack of consumer confidence; this should put downward pressure on retail rents, which then pushes commercial rents down. Your rental estimates need to take national and local issues into account.

In capital city CBD areas, there is often high capital gains and speculative opportunities to combine, refurbish or rezone properties. Investors will pay a premium as they are prepared to accept a lower annual return in exchange for these investment opportunities that can show larger capital gains. In most country areas, the potential for capital growth is negligible so investors can only be attracted by high returns produced by a lower relative purchase price. A reasonable observation would be that CBD properties might sell for down to 3% return while suburban and country properties will range between at 4% to 10% return.

So how does this help in establishing a budget? If in your region you can achieve $300 per square metre per year and your completed property will have 450 square metres of net lettable space, your net income will be $135,000 p.a. Divide that by 6% (the anticipated capital return) to get the completed and fully let value of your building i.e. $135,000/6% = $2.25m. That then becomes your total budget for land and building.

So, working backwards, if you were to buy land and build, your actual budget could look like Table 1.

Table 1	
Budget	$2,250,000
Less	
Building construction	$1,200,000
Design, Council, Consultants	$ 200,000
Land	$ 650,000
Total Cost	**$2,050,000**
Profit	$ 200,000

In this example, a developer would be reluctant to take this on as it shows less than a 10% profit margin. But for a practitioner who will use this building to house his practice, that may not be a major consideration. What this exercise demonstrates is that knowing your building, design, council and extra costs allows you to calculate how much you can pay for the land. Banks also do these calculations and if you are outside their standard financial models, they will find reasons to decline your application.

So all that is left to factor in is the fitout cost. This is not usually provided by a developer, but by the tenants. In many cases, the building may be owned by the practitioners' super fund, with the practice entity being a tenant of the building.

In the next edition,we will look at how to calculate what your practice can afford to pay as rent.

About the author

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