Is gearing commercial property worth the cost and complexity?

By Leon Breytenbach

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Gearing is one of the major contributors to property's popularity and success as an investment, enabling investors to access the benefits of assets far more valuable than their initial cash outlay. When it comes to commercial property, however, gearing involves some significant additional complexities that have deterred many an investor from leveraging this useful financial tool.

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Common deterrents to gearing

There are three main factors that tend to hold commercial property investors back from gearing their purchases. The first is the time and effort involved in securing a loan – a process that can take at least a month in a best-case scenario.

Time

While financing residential property is so commonplace and streamlined that it can be completed within 24 hours, commercial properties have far more variables to be considered. This makes the application process more complex for the investor and accurate risk assessment more complex for the lender, leading to processing times that can extend to several months.

To make matters worse, most bond originators don't handle commercial financing, which means investors need to navigate the application process on their own. This can be daunting as a first-timer, but does get easier as you learn the system and the banks learn more about your business and you.

Pro tip: Always apply for financing at the seller's bank (in addition to a selection of others). They'll be familiar with the property, eager to hold on to an account with an existing risk profile, and keen to gain a new client – great incentives for them to offer you a favourable deal.

Cost

The second major deterrent to commercial property financing and the gearing benefits it brings is its relative expense when compared to residential loans.

With no legislated cap on things like raising fees, things can get expensive. Investors need to prepare for between 1% and 1.5% of their loan amount plus VAT in financing costs, and interest rates of at least prime plus one – except in extraordinary circumstances.

100% loans are extremely rare for commercial properties, and tend to command exorbitant interest rates when they are on offer. As a result, investors typically need access to a sizeable deposit in addition to cash-on-hand for the other transactional costs.

This large upfront investment, together with the expense of financing and the risks of potential interest rate hikes and/or defaulting tenants, can produce the third most common deterrent to commercial property investment: fear.

Fear

Fear is a very real deterrent, particularly for new commercial property investors who aren't necessarily familiar with all the sector's variables. While you can't do much about unexpected interest rate hikes, there are ways to minimise your risk in other areas, like partnering with a good commercial property rental manager to source, screen and manage tenants.

A balancing act

Getting the right balance of financing vs cash investment is also a good way to mitigate risk. Try aiming for the 'sweet spot' of between 55% to 60% financing, which generally enables investors to cover their costs – and any unexpected expenses – with a realistic net rental yield of 10%.

If you have a lower risk appetite, you can weigh your investment more heavily on the cash side, giving you more room in your rental income to accommodate interest rate hikes or other unforeseen expenses. Of course, the less you finance, the fewer benefits you'll reap as part of a gearing strategy – and those benefits can be significant enough to warrant a riskier posture.

While making money with someone else's money is the best-known benefit of gearing, it's far from the only one commercial property investors can leverage.

In commercial property, gearing often enables investors to access more expensive, lower-risk properties, or invest in more than one property in order to spread their risk. That means a theoretically riskier financial posture can produce a more stable and low-risk asset – but you need to do your homework to weigh up those pros and cons.

There are also significant tax benefits to gearing a commercial property, such as writing off the interest on your loan to reduce your overall tax burden. The greater the loan, the greater the write-off – a benefit that can be maximised by leveraging opportunities like UDZ.

Commercial investments within Urban Development Zones have their own tax benefits, which you can access regardless of whether you finance your purchase or not. They can, however, enable you to buy a bigger or better property, thereby maximising both your development and gearing write-offs.

Finding the right balance between all these variables is where the art comes into commercial property investment. It's not easy, but it's also not quite as difficult as it may seem. If you do your research, get sound financial advice and partner with experienced commercial and rental agents, the returns can be well worth the effort involved.

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