The Tourism Property Buyers Guide

Detailed Commentary on the Financial Feasibility of both Freehold and Leasehold Property, as well as Land & Building Investments in the Industry. Accepted industry norms when appraising motel and other accommodation leases, along with commentary on aspects such as depreciation and operating expenses.

The Tourism Property Buyers Guide

This Buyer's Guide is a collection of various articles written at different times and addressing the many aspects of buying and selling in the tourism property industry, mostly relating to accommodation businesses. Readers may wish to select the articles of most interest, however if reading the entire guide there will be some duplication of information.

The table of contents below outlines the detail of each article with a breakdown into various sections or aspects of each subject. The contents of this guide are by no means exhaustive and if more questions are raised as a result of reading it, then all the better. We are happy to field any questions or comments relating to this document or any other aspect of the industry.

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Feasibility of Motels

Issues and questions commonly raised to the assessment of viability for motel and accommodation business leases.

As Tourism Property Brokers, we specialise mainly in the sale of travellers accommodation businesses, with the writer having been involved in this industry since 1984. We do not have the wider knowledge held by accountants who are involved in a much broader range of business assessment, therefore we comment only on the returns offered by this particular industry.

It seems that motel leases are valued in a way which is not consistent with general accounting practises. Sometimes potential buyers receive professional advice not to purchase, this advice is often based on analysis of motel accounts using the more traditional approach whereby cost of capital, return to management and sometimes depreciation are deducted before assessing profitability. In more recent years this has been less of an issue as more accountants have been involved in assessment of motel proposals and have gained a greater understanding of how this particular industry works.

There are many valuers throughout New Zealand who have specialised experience and knowledge in motel valuation. As with all valuations, assessments are usually made on the basis of comparison with recent sales evidence. While sales figures may be available to most valuers, the detail of comparative sales is not so widely available. This is why it is very important to engage valuers with substantial and preferably recent market experience. With a valuation report prepared by a recognised independent valuer, borrowing from main stream banks to purchase accommodation businesses or properties is generally not too difficult. For freehold properties, equity of around 35% to 40% of purchase price is normally required. For leasehold, these can usually be funded on a minimum of 50% to 60% equity. We are happy to provide details of financiers who specialise in this industry and can offer excellent advice and support for your purchase.

How do we value motel leases?

It is beyond the scope of these notes to go into detail about the various factors making up a good lease. There are many variables, however for this exercise we are assuming that we are assessing a leasehold business where the lease is sound and the revenue and profitability are sustainable, or have some growth potential.

Value is usually assessed by establishing the earnings (profit) before interest, depreciation, drawings and taxation, often referred to as E.B.I.D.T. The profit is then multiplied by a factor consistent with other market sales evidence. This factor is referred to as the capitalisation rate or the profit multiple. The rate or multiple used varies depending on a number of matters, not least the location within New Zealand. (See separate article entitled What You Get Is Where You Buy.) Supply and demand in certain regions and their popularity or otherwise will affect the rate of return used. Generally the rates of return for a leasehold business range between 20 to 25%, or in other words four to five times the profit.

Why add back depreciation?

Most businesses claim depreciation on plant and chattels and this may save or at least defer some tax. In the case of say a high tech printing and copying business for example, it is likely that new equipment will need to be purchased quite regularly and that the old equipment will lose a substantial portion of its value in real terms. In this case, depreciation would be a real cost and would need to be allowed for when working out the actual profit of the business.

The chattels in a motel however could be compared to the engine in a car. If agreement can be reached on the total value of the business based on its earnings, then the sum recorded for the chattels in the Sale & Purchase Agreement for the business is mainly important in terms of tax implications for both buyer and seller. There is one qualifier for this though. When calculating motel profitability, it is important to be sure that there has been, and will be, adequate allowance for ongoing repairs, maintenance and replacement of plant and chattels as necessary. (How much will usually depend on the age condition of the assets.) Should an appropriate allowance for chattel repair and replacement have been made, then we would suggest that depreciation on chattels is really a book exercise for tax purposes.

In reality, one of the challenges when negotiating the sale of a motel business, is getting the parties to agree on the sum to be recorded as the chattel figure. The purchaser usually wants to have a high chattel figure so as to be in a position to claim depreciation. The vendor on the other hand would like to show the value at a lower figure, if possible at book value, so as not to recover depreciation claimed on the chattels. In other words, any figure recorded as the chattel value which is above the current closing book value (up to the original cost value) would be depreciation recovered and this would be taxable to the seller. The total business value should not be otherwise affected by the chattel apportionment, except that the "goodwill" or "intangible assets" will need to be adjusted to make up the total purchase price. If a loan application is supported by a registered valuer's report, lenders are not usually too concerned as to the chattel figure, as long as it is reasonable.

Why shouldn't a return to management or owner's salary be taken out of the figures before assessing the profit?

Sometimes such an approach is used in valuations. Some valuers prefer to allow for a manager's salary before arriving at the profit upon which the value of the business is calculated. In this case though, the valuer will use a lower capitalisation rate (or higher multiple) on the profit left over after removal of the manager's salary. The end result may be similar though, if a lower multiple of profit is applied ***before*** removing the owner's salary. Because opinions vary as to the amount that should be allowed for as the owner's salary, we prefer to use the more consistent approach of applying a multiple of profit without taking the manager's return out.

Also, taking a set manager's wage (or owner's salary) out can produce different results depending on the size of the business involved. For example if two motel businesses were selling at 20% return on EBIDT, one for $1,000,000 with a $200,000 bottom line and the other for $300,000 with a $60,000 bottom line, the effect would be as follows. A $50,000 return to the manager from the first example, leaves $150,000 profit or 15% return on purchase price. In the second example though, there is only $10,000 left after removing the owner's return, suggesting that the business is worth little if anything. In the case of the smaller lease, it can be argued that one is only buying a job and to some extent this is true, however it is also a job that can be sold again in the future. Another thing to keep in mind is that a business at this lower level can be bought to satisfy the purchaser's requirements for independence, lifestyle and the benefits of "free living".

Why has the market settled at this level of return for motel leases?

As mentioned at the outset, this document does not intend to comment on specific comparisons for motel returns relative to other small businesses, some of which may show better returns. So why are motels different?

One reason may be the relative stability of the motel industry compared with potential volatility of some other small businesses. Take for example buying a sports shop in a provincial town, this may show a better return on capital and return to management than a motel lease. It may also involve say 60 hours a week and not the 24/7 commitment a motel requires. In this hypothetical example, should Rebel Sports decide to set up a major outlet nearby selling say Nike Shoes for less than the small business owner can buy them, the writing is on the wall. What was a good return on investment may no longer be so and possibly the business could be in jeopardy. Simply put, the bigger player can have huge advantages over the smaller operator.

How does this differ with the motel and accommodation industry in general? A large hotel company, intending to develop, will usually still have to pay market value to buy land. The same applies for building costs and the cost of fixtures and fittings. At today's prices for land and current building costs, developers of new accommodation, large or small, find that the financial viability is questionable at the present tariff structure for accommodation in New Zealand. (Despite the very strong current tourism industry, there is a lot less construction underway then there has been in previous growth cycles.) Also larger accommodation operations do not necessarily enjoy the benefits of economies of scale as in the case of some other industries. Hotels and Motor Inns generally have a far higher fixed overhead structure, particularly in regard to wages. Larger operations also usually require food and beverage facilities to be available and these often run at a loss, which adds to the cost of operation. In other words, a new hotel or motel opening in today's market is unlikely to be able to compete on tariffs if it is to remain viable. When tariffs are able to rise, new complexes tend to set a higher benchmark for the whole industry. This enables older complexes to find more definite market segments in which to operate. In other words, with the new properties being even more expensive, the older ones can compete quite comfortably by offering their standard of accommodation in a different price bracket.

Another factor for the motel operator is the benefit of free living. The running costs of a motel include rent, rates, power, insurance, telephone etc. for the owner. A motelier is able to claim the GST back on these dwelling related costs as well. Accountants use different methods of dealing with this for tax purposes, but the sums declared as a taxable benefit are usually nowhere near the real value of the perk.

Why would I sell a freehold property and buy a lease?

The question is whether available funds are best invested in real estate or into a business. Real estate values can rise and fall, but are generally seen as a fairly safe bet over a reasonable length of time. Motel business values (leases) can also have their ups and downs, however in the past the values have always remained relative to profit. If the owner of a freehold going concern motel (meaning the land and buildings as well as the business and chattels) were to sell the business off by way of lease, a substantial portion of the total value of the motel would be sold. The purchaser is buying a business, not really buying a lease. The lease is of course a very important document and has a bearing on the viability of the whole thing, but it is primarily the vehicle which separates the real estate from the business.

Business values (lease values) over the years have largely remained relative to real estate values. As they say, "past performance does not guarantee future performance", however lease values have increased more or less in line with property values over the last 35 years. This is because the profitability of the businesses have mostly grown along with inflation and other factors affecting tariffs and profits.

There is an important issue with leases though, and that is their value can be reduced by the years running down. As mentioned, the lease is really what separates the business from the real estate, but a lease by its nature must have a limited term. Like many markets, this one does not always behave logically or scientifically and is influenced by the market's perception as to what is a long enough lease term. These days new leases can be 30 or 35 years (sometimes longer). The length of lease can become an issue once it drops under 20 years. The time remaining on the lease does not affect the day to day profit of the business, and a lease with say 15 years remaining clearly still has a considerable length of time to run. If the lease were not extended though, its value may start to decrease as the lease runs further down. If it were to run out completely, the land and building owner would be in a position to just buy back the chattels and then would own the business as well. This very seldom happens though, unless the motel is in a location where the value of the land increases to the point where the motel is no longer the best use for that land. If the landlord took the view that it was best to allow the lease to run right down, then its value would continue to decline. This may not really be in the landlord's best interests though, for a number of reasons. The more the lease is worth the better protection the landlord has that the lessee will continue to pay the rent and look after the premises. As long as the lease has a reasonably good value, it will always be in the lessee's (motel operator's) best interests if they find themselves in financial difficulty, to sell the lease to another party. If the lease had little or no value, it may be tempting to walk away and the landlord would have no tenant and may not be able to find another prepared to pay the same level of rent. If the lease has a low value, the lessee does not have so much to lose nor the landlord so much to gain, by picking up the goodwill of the business by terminating the lease. It makes more sense for the landlord to negotiate a payment to extend the lease before it gets too short. This way the landlord has already received the benefit of the years declining (in other words has been able to charge to extend the lease) and has protected the business value.

The lease will have maintenance provisions which must be implemented, however there can be some difference of opinion as to what is the minimum requirement. A lessee who had a short lease with not much prospect of a good capital sale value would surely have a different attitude towards maintenance. If the lessee can see the benefit of spending money on the property, by way of

improving the profit and as a result the business value, then surely this must benefit the landlord as well. If the lease years and the business were running down, it is also possible that the landlord's ability to increase rent would be reduced in the later years of the lease. This is important to the landlord because the rental income has a direct bearing on the capital value of the property.

For these reasons as well as others, we normally see lease extensions negotiated. The cost of buying more years needs to be taken into account if looking at a motel business where the length of lease is a concern.

Motel leasing has been around since the early 1980's. From the mid to late 80's there was a noticeable growth in motel leasing as a way of separating the real estate from the business. With quite significant growth in property values during the last decade, record low interest rates and a strong demand for commercial investments, the capitalisation rates (rate of return) for land and buildings has dropped significantly. About 65 to 70% of the value of freehold going concern motel is in the land and buildings and these provide a lower return than the business does. So, to buy a motel freehold going concern with most of the money invested in the real estate, the return on investment for an owner operator running a 24/7 operation is quite low as a business return. Separating the two components (see Financial Returns article) so that a business person can obtain a higher rate of return by working the business, while providing the land and building owner with a return appropriate for commercial property investment, seems to work well.

Financial Returns

These notes are based on the writer's experience as a motel broker since 1984. The returns suggested here may be similar also for (some) holiday parks, motor inns and to some extent tourist hotels. In other categories, such as luxury lodges, boutique hotels and B & B operations, the rates of return can be quite different where the underlying real estate value could be higher than the business return may otherwise suggest. Freehold real estate is normally valued on the basis of "highest and best use" and where underlying real estate value exceeds the freehold business value then the higher may apply.

When considering the purchase of a motel business for the first time, it could be helpful to gain an overview of the returns being offered by the current market. These notes are intended to outline the differences in return on investment for each situation. The content of this paper is limited to such comparisons, it does not address the broader subject of valuation. There is no intention to imply that any method of purchase is better than another.

A freehold motel really consists of two main separate components. One is the land and buildings, (the real estate), the other is the business. The business is comprised of basically the chattels and goodwill. (The goodwill is sometimes referred to as the benefit of the lease or the intangible asset.) Even if the complex is owned and operated as one entity, known as the freehold going concern, the distinction still applies. This is relevant, because the returns from the two main components are quite different.

The land and buildings normally earn, by way of rental income, a return on capital of between **6%** and **7%** at this time. The business (lease), will usually achieve a return of around **20%** to **25%**. This profit is based on earnings before interest, depreciation, taxation and drawings for the operators, sometimes referred to in accounting terms as EBIDT. (There are many variables including location,

see separate article What You Get Is Where You Buy.) Because around **65%** to **70%** of the total value usually lies in the land and buildings, which are showing the lower return of the two components, the overall return for a freehold going concern would often be between **10** and **11%**. This is based on a **7%** return for the land and buildings component and a **20%** to **25%** return for the business/lease component.

To illustrate

Current market values as determined by precedent would suggest a motel with a GST exclusive annual turnover of **$360,000** a freehold going concern value of approximately **$2,200,000**. (Of course there are numerous variables to take in to account, the scope of which is not covered by these notes.)

A motel business only, (by way of lease), with a GST exclusive annual turnover of **$360,000,** with "average" operating costs and appropriate rental, should sell for between **$500,000** and **$600,000,** depending on locality and other factors.

So

Land & buildings value	***say***	***$1,710,000***
Business value (assuming a good lease)	***say***	***$520,000***
Freehold going concern value	***therefore***	***$2,230,000***

Leasehold

"Rules of thumb" can be dangerous to use in isolation, so please do not take these notes as being definitive. For the sake of this illustration however, we shall use such an approach. There is an old rule of thumb for motel leases, which says that the total turnover from the business can be divided by three. One third each being apportioned to running costs, rent and profit. These cost ratios are changing with an ever-increasing percentage of revenue being paid to Online Travel Agents (OTA's), however that is another subject. (The biggest single factor affecting running costs as a percentage of revenue, is the average room rate achieved by the motel - low rates mean smaller profit margins and higher costs. Some of today's upmarket motels are able to charge considerably higher tariffs, whilst keeping their costs similar to lower market properties. This results in higher profits and conversely lower costs as a percentage of revenue.)

For the sake of this example, we take one third each being apportioned to running costs, rent and profit.

So a turnover of **$360,000** in this case, would go something like this:

• ***Annual G.S.T. exclusive turnover***	***$360,000***
• ***Rent say***	***$120,000***
• ***Running costs say***	***$120,000***

• Profit, before interest, tax and return to management therefore ***$120,000***

This profit of **$120,000,** represents **20%** of the value of the business at **$600,000** or **25%** at **$480,000**. Current interest rates are of course considerably lower than that, so in this case borrowed funds are more than self-servicing. From a cash flow perspective however, keep in mind that principal will usually need to be repaid over a period of 5 to 7 years.

Funding is usually available for motel leases for up to 50% of purchase price or valuation. In some cases higher loan ratios can be obtained, however this should not be relied on. If calculating your price range on the basis or your equity before borrowing, it pays to allow for **$15,000** to **$25,000** over and above the purchase price, to cover various apportionments and start-up costs. Depending on the time of year, upfront payment for prepaid advertising can add considerably to the funds required on settlement. Please ask your broker what to expect given the time of year of your purchase.

Freehold

For a freehold going concern there would normally be no rent payable. The owner/operator in this example would effectively have **$1,700,000** invested in the land and buildings. The benefits of this would include the saving in rent of **$120,000** pa, being approx. **7%** on that investment.

The overall return for the freehold going concern is not the average of both components. This is because the majority of the investment is in the land and buildings, which give the lower return of the two.

Thus

Turnover **$360,000** less running costs of **$120,000** = **$240,000**.

$240,000 represents **10.76%** of the freehold going concern value of **$2,230,000**.

Lending institutions have always favoured land and building security, however they will recognise the value of the business component (chattels and goodwill) in a freehold going concern. Working on a maximum of about **60%** borrowing on total purchase price would be advisable when calculating purchasing power in these current times. In the case of freehold, repayment periods are generally much longer than for leases, so this helps with cash flow.

Other Pros and Cons

In a freehold going concern situation, the motelier has the advantage of accruing the benefit of the appreciation of the land and buildings. The owner's outgoings or returns in this respect remain relative to interest rates and inflation.

The owner of the business, by way of lease, must consider the prospect of increased rentals, in line with inflationary pressures and income trends. This of course, would presuppose that market values are rising, in which case the value of the lessee's business should be growing, along with the profits.

It is not the intention to discuss here, by comparison with other options, the merits or otherwise of investment in this industry. There is a factor to bear in mind though, if making such comparisons. All returns suggested here are not inclusive of the value of "free living". Living on site is an integral part of a motel business. All dwelling related living costs (rates, power, phone, insurance etc.) and some

others, are covered by the operating costs of the motel. There will be a variance of opinion in quantifying the value of this benefit. That is left up to individuals and their advisers to assess.

Summary

So the question may be, should I look at leasehold or freehold?

It is very much a matter of whether the purchaser feels that they have enough equity to purchase a business, as well as the real estate from which it operates. Would the capital be best utilised at a higher return by putting it all into a business? Buying an investment property would normally imply that one has reserve capital to invest. If a good business is purchased and shows high cash returns, this may put one in the position to increase equity over time.

If sufficient capital is available at the time of purchase, then a freehold going concern is twofold investment. It also gives the operator the opportunity to sell the business and retain the land and buildings as an investment.

What Am I Buying?

When a business is advertised for sale as a lease, this means that it is the business only for sale and not the real estate. This is how very many businesses operate in today's commercial environment, however it does cause some confusion in the accommodation industry. The lease document is critically important in the purchase of any business which operates from commercial premises. The terms of the lease are most important in underpinning the value of the business asset being sold (chattels and "goodwill") but it is not what sets the value. The value of the business is determined by its profitability, after all outgoings, including rent for the land and buildings.

Freehold Going Concerns Financial Returns

What should be expected?

A freehold accommodation business is made up of two main components. One is the land and buildings (the real estate), the other is the business. The business is comprised of the plant, chattels and goodwill. (The goodwill is sometimes referred to as the benefit of the lease or the intangible asset.) Even if the complex is owned and operated as one entity, known as the freehold going concern, the distinction still applies. This is relevant, because the returns from these two main components are quite different.

The land and buildings, if owned and leased out as a separate commercial investment, would normally show a return of between **6%** and **7%** at this time. The business (lease), will usually achieve a return of around **20%** to **25%**. This business return is based on earnings before interest, depreciation, taxation and drawings for the operators, often referred to in accounting terms as EBIDTA.

Because around **65%** to **70%** of the total value usually lies in the land and buildings, which are showing the lower return of the two components, the overall return for a freehold going is often between **10%**

and **11%.** (Some recent sales have evidenced considerably lower yields.) This is based on a **7%** return for the land and buildings component and a **20%** to **25%** return for the business/lease component.

We believe that most freehold operations in this industry are currently being sold at well below replacement cost, which could suggest that now is a good time to be entering the market. In the last decade we have seen a huge increase in building, consenting and compliance costs and in many cases land costs. During the same period in many locations, there has been significantly less increase in accommodation tariffs, which is now probably overdue. Whilst there is some construction of new accommodation property in parts of New Zealand, the amount of new supply coming online is unlikely to be enough to cater to existing and growing demand.

Any questions or comments on this subject would be very welcome.

Understanding the Commercial Accommodation Lease

The majority of new entrants to the motel or accommodation industry will have purchased their business by way of lease. For many, this will be their first encounter with a commercial lease and it often seems that some aspects of commercial leasing may not be fully understood.

It is not uncommon when purchasing a business of any type, that it is just the business changing hands and the ownership of the commercial premises from which it operates, is a separate issue. Some businesses can be moveable, for example a retail store could shift to different premises in the event that the lease came to an end or was terminated. On the other hand, a purpose built property, such as a motel, hotel or lodge means that the lessee (business operator) is reliant on the continued occupation of those premises in order to remain in that business. For this reason, these types of leases tend to be for much longer periods to give the operators security and, in most cases are registered. Under the electronic Computer Interest Register a registered lease of a commercial property produces a leasehold title. A registered lease has advantages, not only security of tenure but also usually the ability to mortgage the leasehold interest, which is helpful when borrowing to buy the business.

Grievances aired by lessees, often relate to the lack of contribution from the landlord in terms of costs and outgoings, particularly around building maintenance. Most commercial leases in this industry are known as “net leases” meaning that the lessee (tenant) is responsible for all outgoings, including rates, landlord’s building insurance (as well as their own business insurance) and repairs and maintenance. This seems rather oppressive when compared to a residential lease and would appear to be a common cause of misunderstanding.

Landlords remain responsible for weather-proofing and structural integrity, however this is seldom an issue in a properly constructed modern building. What seems onerous, is that in many leases, the lessee is not only responsible for maintaining landlord’s fixtures and fittings, but quite often is also responsible for replacing them as they wear out. The lessee will own the chattels and it is logical that they will wish to maintain and replace these as required to keep the business operation to a high standard. However replacement of such things as bench tops, shower linings, toilet pans etc., seems to be a cause of concern. If these matters are fully understood at the outset, then the purchaser of

an accommodation business could be better aware of their obligations under the lease. They may be more inclined to ensure that their purchase takes into account the condition of the landlord's fixtures and fittings for which they may be responsible, relative to the wording of the actual lease in question. Some landlords are more helpful than others and it is not uncommon for them to contribute in respect of upgrades of lessor's fixtures and fittings. However unless it is in the lease that the landlord will be responsible for such expenditure, then this is best not to be taken for granted.

As mentioned, leases in this industry need to be of considerable length to secure the business value, however by their nature they must be for a finite term. To address this, leases have gradually got longer since first commencing in the 1980's. New leases are now commonly for 30 or 35 years (sometimes longer). There comes a time when the reduced length of the lease can be an issue for re-sale purposes. This is something the industry is generally aware of, certainly valuers and banks when it comes to lending. From a lessee's point of view, usually the longer the lease the better and, there is often an opportunity to negotiate further extensions or rights of renewal with the landlord. As with building maintenance, landlords' attitudes to this aspect will vary. Extensions are sometimes granted at no cost, whereas other building owners seek exorbitant sums for them.

An innovation in the 2012 released MANZ (now Hospitality New Zealand) endorsed draft lease, was the inclusion of an extension mechanism as part of the lease. We have seen a number of these leases accepted by the market since that time, which is a positive thing. This provides the leaseholders with more certainty as to what needs to be allowed for, to purchase lease extensions, as they become necessary. This is a relatively new aspect to leasing and not widespread at this stage, but hopefully it will become so.

Motel leasing has been around for over 35 years now. There are practical commercial reasons for separating the two entities of commercial property investment and business ownership, not least the significantly different returns from each component. It would seem that this method is here to stay and, it is likely that those with an interest in the industry will continue to refine and improve the structure.

Depreciation - A Painful Recovery?

When selling a motel or other accommodation operation, the business value is generally appraised on an over-all basis to arrive at a figure relative to return on investment offered. The chattels are usually not assessed separately and, provided an adequate repairs, maintenance and replacement program has been implemented, their "insitu" value should remain relatively steady. The issue which almost always arises however, is the apportionment to tangible assets on the sale and purchase agreement. The tangible assets (plant and chattels) will usually have been depreciated on the books for tax purposes. The sum calculated for depreciation will be deducted from the taxable income and therefore reduce the tax liability for the operator in that financial year.

The problem arises when it comes to selling. The purchaser (or their accountant) will normally like to see a high chattel figure apportioned on the agreement, so as to be in a position to also claim a reasonable amount for depreciation. The vendor on the other hand would like to show the chattel

value as low as possible, if possible at book value or close to, so as not to recover the depreciation previously claimed. Any value apportioned to the tangible assets over and above book value, up to the original cost value, will be treated as income in the year of sale. Whilst the seller is not really paying any additional tax, rather just paying tax that they have been able to defer, the tax in the year of sale can be a painful and sometimes unexpected liability. Further to this, the depreciation will have been claimed in gradual amounts at the tax rate applicable to the overall income for each financial year. If and when all of the depreciation is recovered in one year, it may effectively increase the taxable income for the operator to a higher tax bracket. If so, recovered depreciation may be taxed at a higher rate than has been claimed along the way.

The process of reaching an agreement for the purchase of a business normally involves a certain amount of negotiation. The sum apportioned to tangible assets can certainly be part of that negotiation. An astute purchaser may buy at a better price if they see the advantage in agreeing to a lower chattel figure, reducing the vendor's tax liability. This of course means that the purchaser's ability to claim depreciation will be reduced due to the lower figure as a starting point. We believe though that this may be a good strategy for a couple of reasons. Firstly, as mentioned above, chattel depreciation may not be saving tax but rather just deferring it until the time of sale. A lower depreciation claim therefore is going to result in less recovery in the future. The other twist is that capital gain on chattels is not taxable. If the purchaser buys at a low chattel figure and claims little or no depreciation, they have less to lose (tax to pay) by offering quite a high chattel figure at the time they sell. This would enable the next purchaser to benefit from the higher depreciation claims. In other words, it has gone the full circle. If the chattel figure is high enough, the next owner may be able to claim a reasonable amount of depreciation and still be able to sell at, or close to their book value later on. An "arm's length" sale and purchase agreement between two unrelated parties is normally sufficient documentation as to the agreed sale and purchase price for the chattels.

It is not compulsory to claim depreciation on chattels or other tangible assets. If a business owner elects not to depreciate the chattels at the outset, they can leave them on their books at the same figure, (plus any additional chattels purchased) and that will not be problem for them when they sell. (They would also be able to offer a higher figure which would be a tax free capital gain.) This way, the business owner knows that their tax liability is up to date at all times and they are not building up a potential depreciation recovery issue.

The intangible asset of "goodwill" is often split on a sale agreement and allocated to business goodwill and lease goodwill, the latter sometimes referred to as the benefit of the lease. The lease goodwill can be depreciated, which is termed amortisation, usually on a "straight line" basis. (As opposed to chattels which are depreciated on a reducing value basis.) This means that the figure for lease goodwill is divided equally by the number of years left on the lease and that sum is written off against income at the same amount each year. Whilst the amount of depreciation (amortisation) claimed for this aspect is usually less than the chattel depreciation, we often find that the closing book value figure is acceptable to a purchaser. This may be because the lease goodwill component is not always available and therefore seen as a bonus to be able to claim this extra depreciation. If the lease goodwill were to be recorded in a sale agreement at higher than closing book value, then the surplus over book value would be taxable.

In the case of land and buildings such as an investment property or a freehold going concern, the buildings, in most cases, are no longer able to be depreciated for tax purposes. The owner of the real

estate though, may have been claiming depreciation up until the commencement of the 2011/12 income year, when the depreciation rate for buildings (with an estimated useful life of 50 years or more) was reduced to zero %. The building owner will therefore sometimes face the same depreciation recovery issues on sale. Given that the purchaser is not able to claim depreciation on the building component (a situation which seems unlikely to change in the future), then there is again the possibility for them to make the proposal more attractive to the vendor by offering to buy the buildings at or close to book value.

It must be stressed that this article is in no way intended to offer tax, legal or accounting advice. One should always consult with a qualified professional on matters such as this. If we are able to provide further clarification or information on this topic, we would be pleased to do so.

What You Get Is Where You Buy

It may come as a surprise to hear that the rates of return on investment for motel and accommodation businesses can be quite different throughout the country. So, where you buy may largely determine the return you could expect.

Using motels as an example, purchasing a long lease for a good business in most parts the South Island will usually yield a net return of around 20% on ingoing price, with slightly higher returns likely to be found on the West Coast. Go to the lower North Island and the returns are commonly 23 - 25% and further north the ROI can be up to 30% or more. (Higher yields mean lower prices relative to profit.) While the South Island seems to have the same rate applied almost throughout, the North Island tends to vary depending on location. So how did this come about and why does it continue?

The best explanation that we can come up with, is that it is simply because the markets have evolved separately and independently. As with most aspects of real estate and business sales, values are assessed by way of comparison with relevant sales evidence and, the precedents set in various localities have been different. When registered valuers produce their reports, most seldom if ever use sales evidence from the other Island and, it could be argued that such distant evidence may be less than relevant.

Apart from valuers looking at the history, it is possible that the motel brokers at the coalface might have a bit to do with this. Ours is a specialised industry and perhaps it can be influenced by a smaller number of people who are most active in this particular niche. Motel leasing only really started in the 1980's and the few brokers who have been around since that time had not substantially and successfully ventured inter-island with their activities. Apart from pricing, we can also observe how different aspects of the actual lease document have developed in slightly different ways in different regions. Coffeys has been operating in the South Island since 1984 and never really seriously looked north until 2009. Now that we are operating successfully New Zealand wide, we are in a position to observe this apparent anomaly on more than just a casual basis.

By way of further illustration, Australia's (eastern) market has developed quite differently to New Zealand. There will no doubt be a number of factors at play here, but in Australia they seem to get far better returns on their motel leases and freeholds, however they pay more for management rights, i.e. lower returns than ours. Motel leasehold returns can be seen advertised at up around 28 - 30%

(depending on how close to the coast they are) and freehold going concerns show considerably better returns than ours do as well. Looking then at management rights, it seems that the Aussie's are being asked to buy at around 20% return on purchase price for the management rights themselves, (five times net profit or more) plus they usually have to buy their apartment on top of that. Return on total investment can end up being 11% to 13%.

We don't see any reason for this situation to change to drastically in the near future. If that is the case then it should be borne in mind that whatever price one pays in any given locality, there is a reasonably good chance that the business will be bought and sold in the future under similar market conditions.

Motel Land & Building Investments

What Is The Attraction Of Motel Investment?

Readers who already have commercial property investments will understand the advantages over residential. Clearly there are some disadvantages, such as a higher priced entry level and, generally the ability to borrow for more leverage is curtailed by the banks requiring greater equity levels. Certain types of commercial property can carry more risk than residential, but more on risk later.

For those contemplating a commercial investment for the first time, we point out that the commercial landlord usually receives what is known as a "net" rental. This means that the lessee (tenant) is responsible for all outgoings, including rates, building insurance and repairs and maintenance. In a motel lease, the landlord is usually responsible only for weather-proofing and structural integrity. Weather-proofing is seldom an issue in a properly constructed modern building. Structural issues are also unlikely to be a problem, however one would certainly wish to verify this when purchasing an investment property. It would also pay to establish the building's seismic rating.

Almost all commercial properties operate on reasonably long term leases (compared to residential), meaning that the landlord does not have to be concerned with finding new tenants as parties come and go, or worry about minor maintenance issues etc. In the case of motels, leases are for an exceptionally long period, up to 35 years. This sounds good from a landlord's point of view, however it is also desired by the lessee. The majority of moteliers these days operate under leases, meaning that they own their business (including plant and chattels) but not the real estate from which it operates. When the businesses are bought and sold (as they will do a number of times during the term of the lease), it is considered important that there is a long term lease in place in order to give secure tenure to the incoming operator. So, apart from the landlord starting with the benefit of a very long term lease, as the leases get shorter, the lessees generally look to extend them for sale purposes. This can also involve a payment to the landlord, which is a bonus over and above the rate of return provided by the rent.

In most commercial properties, the lease itself usually has no monetary value. Occasionally there may be a premium paid to secure the lease for a very good retail/hospitality site or office development, this is sometimes referred to as site goodwill or key money. Generally though, the business is moveable and can be taken from one commercial location to another. Because the business of a motel is inseparable from its building, the long term lease usually has a substantial market value. Motel operators pay significant sums of money to purchase their business and this capital is what they stand

to lose should they find themselves in breach of the lease. Additionally, it is not uncommon to see the lessee making significant improvements to the property, in terms of refurbishment of décor, fixtures and fittings. Whilst other commercial tenants will often try to enhance the value of their business similarly, it is frequently the case that their fixtures and fittings are of little or no value to the landlord should they move on. This is not the situation of course with a motel. With hundreds of thousands of dollars at stake, one could consider this a very substantial bond.

What Are The Risks?

There is always potential risk with any type of investment, so it would seem logical to suggest that the property type that offers the least amount of risk would be most desirable. One way of measuring risk is by considering what options are available should things go wrong.

Investors starting out, often prefer the security of residential property because they know that a dwelling can always be let at a price, reduced if necessary, under normal circumstances. A retail outlet in a shopping strip or a commercial or industrial building on the other hand, could become empty either because the lessee has elected not to renew their lease or has gone out of business. Sometimes these properties can sit vacant for a considerable period of time and may even require capital expenditure by the landlord to adapt the building for a new tenant. An empty commercial building such as this does not generate any cash flow. The motel business remains inseparable from the real estate and a landlord in possession could appoint a manager and continue to derive income from the business. Given that the lessee has invested so much in the business/lease, in the event of difficulties one of two things may happen first:

1. The lessee may look to sell at a reduced price in order to attract a buyer, rather than lose all of their equity in the business by letting the lease go in to default.

2. It is often the case that the lessee has borrowed against the business, (apart from the chattel securities, registered leases can be mortgaged by lenders) and that the lender would move to protect its security. As part of a loan agreement, the lender would normally require an agreement from the landlord to consult with them in the event of any problems, so that they may step in to protect their interests. If for example the lessee was failing to pay the rent, the landlord may issue a notice to terminate the lease, whereby the lender would have the option of paying the rent on behalf of the borrower so that it may market the business for sale, at probably a significantly reduced price. The maximum most lenders would advance against a motel lease would be 50% of valuation, so this gives the mortgagee a lot of room to move in terms of on-selling the leasehold interest.

In the event that neither of these scenarios play out and the landlord ends up in possession of the motel, there are a number of options. As undesirable as it is to see a motel business fail in this way, the commercial reality is that it can sometimes be seen as a windfall for the landlord. The lessee will often have paid $500,000 upwards for the business and the landlord would usually have the option to purchase the chattels at in-situ value, which would be a small percentage of that amount. As an additional buffer for the landlord, any rental arrears could probably be deducted from the sum payable for the chattels. This sum would be payable either to the lessee or the lender who had a charge over such chattels. The landlord would be able to on-sell the lease and recoup some goodwill from that sale or as previously mentioned, put management in place to keep the cash flow coming in and look to build the business up again to its former value.

As an offset, one must consider that if the business were to be re-leased at a lower rental, then by capitalisation of the reduction in rental, the land and building value could be reduced by a reasonably significant sum. This sum may well be in excess of any gain picked up by the landlord from the sale of the goodwill on the new lease. This is probably a worst case scenario. There is however a potential solution to this situation as well.

We have been involved in some of the rare cases where the lessee's business has failed and the landlord has taken possession of the business. A new lessee has been found who was prepared to pay a certain sum of goodwill for the business (over and above the chattel value) on the basis that a stepped or tiered rental structure was implemented. The landlord was able to set the "passing" rental at the level of rent prior to the failure of the previous lessee. This was done by providing an incentive to the incoming lessee, such that the rent would be discounted for the first two or three years enabling the new operator time to rebuild the business before having to pay rental at the previous market level. This assumes that the previous market level was reasonable by market comparisons and would be sustainable under normal circumstances. (When buying a motel investment once should of course ascertain that the current rental is sustainable under normal circumstances.) The buildings were then able to be valued and/or sold on the basis of the passing rental, with the discounted sum in the interim being accounted for on a dollar for dollar basis. In other words, the reduction in rental in the first two or three years detracts from the land and building value on a dollar for dollar basis, not on a capitalised multiple of that discounted rental. We appreciate that this can be a complex subject and we welcome any queries about this.

We imagine that less desirable outcomes could be possible. The point being made here is that should things go wrong, there are a lot more options in these situations than perhaps in some other types of investment categories.

The Current Market

As motel brokers, we have always found a ready market for motel investment properties. We believe that this is for the reasons stated above and is evidenced by most investors taking a long term position with their properties. We would not be able to sustain a business from repeat clients in this regard as motel investors do not usually come back to us to sell on a cyclical basis, as the business owners do. (In fact if we hear from them again at all it is often to buy another motel investment property, or perhaps to seek advice at rent review time.)

We trust that this information is helpful to anyone contemplating motels or accommodation property as an investment. Any questions or comments would be most welcome.

Management Rights

The intention of this article is to provide a brief overview of the operation of Management Rights in New Zealand. There are many variables in the way these businesses operate and it is beyond the scope of these notes to cover all of those. Suffice to say, that Management Rights have been operating in Australia for many years, often on a smaller scale by expat Kiwis but also on a large scale by publicly listed companies.

Essentially the business of Management Rights is the operation of an accommodation business, similar to running say a motel. Usually the units or apartments are run as short-stay travellers accommodation, however in some cases they are let as residential tenancies.

The units or apartments are usually on their own titles, with the collective owners making up what is called the Body Corporate. In Australia, where the industry is regulated, most contracts operate on more or less the same basis. In New Zealand the industry is not regulated and subsequently there are many variables and different types of contracts.

The main difference between operating under this arrangement, compared to say leasing a motel or any other building, is that the Manager is not paying a set rental. The revenue is split between the Owner of the apartment and the Manager, with some of the costs of operation being shared between them. The income for both the Owners and Manager will therefore vary depending on the tariff and level of occupancy achieved for the apartments. This can be less onerous for the Manager than a set rent when business is slow, however when it is brisk then the holder of a lease on a set rental would reap the full benefit of any revenue above expectations.

The Manager's share can be anything from 10% to 50% of accommodation receipts. The split of revenue between the Owner and the Manager varies according to how the operating costs are allocated. Typically, the Owner would receive directly the bills for rates, insurance and electricity. The Manager would account to the Owners on a monthly basis with a statement outlining the revenue from the apartment, less the Manager's share and less other items such as proportion of common area electricity, telephone line rentals, Sky TV and in many cases consumables and cleaning and laundry services. The Manager will generally pay the cost of operating their own business, including office expenses, phone charges, cleaning and laundry costs (depending on the split), accountancy, bank charges, postage and stationery etc. The Manager may also earn additional revenue from ancillary services provided directly to the guests, such as valet services, arranging of transport and provision of additional food and beverages and commission on the sale of third party tourist activities.

The Owners would also pay an annual Body Corporate levy, which would contribute to overall Body Corporate costs, including payment of either a Manager's salary or remuneration for looking after the common areas of the property. The Owners are often levied for a sinking fund for repairs, chattel replacements and refurbishment as required. A small percentage can also be levied against Owners income for advertising and marketing. Often this is topped up by the Manager who naturally has an incentive to promote the property.

The security of the Manager's tenure can vary. Ideally, the contracts would be secured by a three-way relationship. The Manager would have a long term contract with the Body Corporate and the individual Owners are bound by the Body Corporate rules and constitution. Each Owner then usually has an individual contract with the Manager, drawn up within the parameters of the Body Corporate – Manager contract.

In most cases, whilst in the letting pool, the Owners have some rights to use their own apartment short term, and can if they wish withdraw from the letting pool by giving suitable notice. In purchasing a Management Rights business, there can technically be a risk that the letting pool would dwindle, however in reality this is seldom the case. Anyone wishing to own and occupy a residential apartment, would probably look for a different environment than that provided by a commercially managed

apartment complex. Some management agreements are secured by individual registered leases from the Owners to the Manager, providing the manager with total security of tenure.

In addition to the purchase of the Management Rights contracts, the Managers usually buy their own apartment as well, however there are exceptions.

Similar to the lease of a motel, the businesses will often change hands a number of times throughout the tenure of the contracts. The value of the contracts will remain relative to the profits generated and the prevailing rate of return accepted by the market at the time.

In summary, the industry offers good returns and in many cases has advantages over the more traditional ways of operating in the accommodation industry. We expect to see the growth in the New Zealand market continue in the future.

Bed & Breakfast Operations - A Popular Choice

There are a good many Bed & Breakfast establishments throughout New Zealand and they offer a unique and distinctive accommodation experience for the guest. These broadly include homestays, farmstays and accommodation provided in heritage and/or luxury buildings. Locations range from convenient city addresses to remote and isolated get-away settings.

B&B's offer a more personalised experience, often reflecting the character and tastes of the hosts to a greater extent than would be experienced in most commercial accommodation. Generally B&B's are a smaller operation where the hosts have a great deal more personal interaction with their guests. The package generally includes at least breakfast of course, but often other meals are available as well. Operators are able to join the Bed & Breakfast Association of New Zealand for industry support (www.bandbassociation.co.nz).

It would seem that the Bed & Breakfast style of accommodation business model is of considerable interest to aspiring operators. When analysing our keywords for (website) search engine optimisation, it is apparent that the search for B&B's for sale ranks very highly. We would prefer to be in a position to offer more such listings to the market.

When appraising the value of a freehold accommodation operation such as a motel or hotel, certain formulae are used to establish the commercial freehold going concern value based on bottom line profits. We often find with smaller B&B operations that this approach on its own may not support the underlying real estate value. When this is the case, then the higher of the two values would prevail. and it may well be that the property will fetch the best price by being sold in the local market based on comparative residential sales in the area. Clearly a home suitable for a B&B must have a reasonable number of bedrooms and so will perhaps be larger than the average residence, it is likely to be comparable to other top end residential properties in the market.

We are always pleased to hear from any Bed & Breakfast operators who would like to discuss listing their property for sale and of course from any parties interested in purchasing into the industry. Any questions or comments on various aspects of this particular niche would be most welcome.

For further articles relevant to this industry, updates are always being added to our website at http://www.coffeys.co.nz/News-Articles/

This Buyer's Guide is a compilation of articles written at various times and will also be updated with new articles as they are completed. The publication of these articles can only provide relatively brief overviews of the subject and we would welcome any further questions or comments on any matters raised. Part of Coffeys' philosophy is to wherever possible, add value to the industry. For anyone wishing to see articles addressing other aspects, we would welcome feedback.

With best wishes for successful ventures.

Kelvyn Coffey
Principal