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Registered Public Valuers
217 West Street
Ashburton
P.O. Box 119

14 September 2018

David Harford Consulting Limited
PO Box 603
Ashburton 7700

Attention: David Harford

Dear Sir

229 West Street, Ashburton – Cates building, development and rental/sale issues

1. I have been asked by Barry Redmond of Redmond Retail Ltd (the company) to provide an assessment of the prospects of the company obtaining any reasonable financial return on the Cates Grain Store building at 229 West Street (the building), in central Ashburton, if it is required to strengthen the building and bring it as close as possible to complying with the building code as part of any change of use. I have also been asked to look at the same issues in respect of an alternative proposal that I have been told has been referred to as the "Gilkison proposal" that would involve the removal of the rear extension of the building and the reinstatement of the original building by removing alterations made in the 1960s/70s to each side and to the street facade and to maintain as much of the interior heritage features as possible.

2. In addition to this, I have been asked by the company's legal counsel to consider the matters under section 85 of the Resource Management Act. As I have said below, he has explained the section 85 matters to me as requiring assessing whether the building is incapable of reasonable use and whether the heritage listing of the building in the District Plan places an unfair and unreasonable burden on the company as the owner. I deal with these matters at the end of this report.

Qualifications and experience

3. My qualifications and experience can be summarised as follows:

4. a. I hold a current Valuer's Practice Certificate. In 2007 I became a Registered Valuer.

   b. I am an associate of the Institute of Valuer's (ANZIV)

   c. I am a senior member of the Property Institute of New Zealand (SPINZ)

   d. I am an associate of the Real Estate Institute (AREINZ)

   e. I hold a Batchelor of Commerce Major in Valuation and Property Management (Lincoln University) Post Graduate in Business (Massey University)

   f. I am actively involved in Commercial sales and leasing within the Ashburton market.

   g. I am actively valuing in the Ashburton Commercial property market.

i. I have practiced as a valuer and commercial sales within Ashburton since 2001.

Adaptive reuse of heritage or older buildings

5. There has been a limited amount of conversions of older buildings in Ashburton for a new use (adaptive use) to meet current market requirements of commercial tenants.

6. I have been involved in a warehouse conversion into office tenancies at 217 West Street, Ashburton. My involvement included feasibility and project management. In this particular case the conversion was relatively straight forward due to the simple clear span 1960's building design. This conversion involved change of use, structural building upgrade, accessible person facilities and upgrade of fire systems. This building adjoins the subject property and is currently occupied by KPMG and Genesis Private Equity group.

7. With this particular building there were limitations in creating separate amenities and two separate tenancies while complying with the fire regulations to ensure sufficient means of escape. The security of each tenancy was comprised with the design as this was required to have shared toilet facilities whereby each tenancy has a means of escape accessed through each other's tenancy. The solution was not ideal as it comprised the security of each business. The accessible person's access was not able to be achieved due to the building height. This also required an alternative means of entry via another tenancy within the building. There was some extra cost and time delays to achieve the suitable solutions. In this particular case the strengthening of the building was relatively cost effective which is often not the case with many older buildings.

8. Other buildings that have been converted within the town include the Speights Ale House on the corner of Burnett and Cass Streets at 246 Burnett Street, Ashburton. This was previously occupied by Westpac Bank where the majority of earthquake strengthening had already occurred prior to the change of use. The property was used by Agricom, an agricultural based business utilising the property for offices. It was then purchased by the Ashburton Licensing Trust and converted to its current hospitality use.

9. The Braided Rivers restaurant on the opposite corner of Burnett and Cass Street at 246 Burnett Street, Ashburton was previously used as a car dealership and service centre occupied by a business called Smallbones. This property was purchased by a local investor and converted into hospitality occupied by the Ashburton Licensing Trust at the time. We have undertaken valuation work on this property and the owner advised that the final costs of conversion was some 30%-50% above initial cost estimate. These increased costs due to unforeseen requirements.

10. Often the conversion of an older or heritage building can compromise its design and function resulting in an inferior building to a purpose-built modern equivalent. The KPMG building which I was involved in the development of appeals to a smaller market due to the reduced security by the Building Act requirements for the means of escape and greater requirements for disabled person's access. From a marketing perspective this undoubtedly both reduces the functionality and increases the operational costs of many heritage buildings and older buildings and therefore the size of the market of suitable tenants. In many cases, the requirements for earthquake strengthening and subsequent refurbishment has the unfortunate consequence of increasing the rental costs to meet the building owner's redevelopment costs while at the same time reducing the amount of usable floor area. Therefore many older buildings are simply not financially feasible to develop.

11. I consider there is a preference in the market for new builds over converted older buildings. A reasonable amount of this preference is driven by design limitations for conversion of older properties. Older buildings often have a significant amount of obsolescence which is difficult to convert when competing for tenants over a purpose built new building.

    a. From a marketing perspective both require initial tenant interest before any significant investment is made by the developer. It is typically easier to do so for a new build which often has greater flexibility and building design in meeting tenant requirements. A heritage building that is adapted for reuse may be limited in many ways including permitted use, structural walls, location of services, lack of services now required under the building code such as fire control and egress requirements and disabled access, and protection of heritage features which can conflict with a potential tenant's fit-out, branding and signage requirements. For example, Mr Harford, advises that even if the Cates building was fully restored and tenanted, any material change in the size, dimensions, or location of buildings signage would most likely require resource consent.

    b. In the case of the Cates building we understand the original building, once strengthened and refurbished, could potentially significantly reduce the rentable floor area of the building. The reduction in rentable floor area does have a direct impact on the achievable rental return and therefore the property value.

    c. In the case of this property, I consider the most significant impact to affect the financial viability is the limitations of achieving a financial return. I consider as long as the building is safe to occupy there is a market to lease the premise however this maybe at a limited financial return. An earthquake prone building in its current form has a limited use. The ability to lease an earthquake prone building is further reduced by potential limitations with insurance cover and a limited duration available to occupy the building under the Earthquake Amendment Act 2016.

    d. If this building was upgraded to enable a change of use (for an office, retail, or hospitality use), and refurbished to a tenantable standard, I still consider that the realistic lease or sale prospects of the building in the commercial market in Ashburton would be only marginally increased. Any marginal increase in rental would achieve a nil to marginal return on investment. i.e. I do not consider the proposed structural upgrade and refurbishment of this property to be a feasible commercial investment.

    e. The commercial reality of upgrading older buildings to meet earthquake NBS requirements is not financially feasible in many cases. The effects of the Building (Earthquake-prone Buildings) Amendment Act 2016 is that many commercial buildings are being demolished as the required earthquake strengthening is uneconomic and provides no return on investment.

    f. This most probable alternative use in my view would be either bulk retail or hospitality. The office market in Ashburton is currently experiencing an oversupply which is likely to be a long-term situation. With increased supply and competition it is possible that the office rental market experiences a lowering of market rental. Office tenancies are more costly to fit out. As a guide:

Basic standard	\$560/m² to \$660/m²
Medium standard	\$670/m² to \$870/m²
High standard	\$930/m² to \$1,230/m²

g. Retail buildings generally have a low base development cost and the fit out is generally at a lower level of $330/m^2 to $380/m^2 plus air conditioning costs.

h. Due to the lower development cost for bulk retail and the very competitive office market we have investigated the feasibility for a change of use to a bulk retail use later in this report.

Sale of the building

12. I received instructions from Barry Redmond on the 18th July 2017 to market the property for either sale or lease. This property was extensively marketed through Property Brokers – Hastings McLeod Ltd. The two commercial sales people working on the sale and lease were Hamish Niles and myself. Collectively we have over 40 years of real estate experience in the Ashburton commercial property market.

13. Redmond Retail Ltd accepted our recommendation of an extensive marketing campaign. This marketing focused on the wider Canterbury region through local newspapers plus national coverage through all major property websites. Direct marketing investment of $2,125 plus GST plus another $1,500 plus GST of indirect costs being a total investment of $3,625 plus GST of marketing.

14. This marketing campaign was focused over a 4 week period which is the typical marketing timeframe for a property of this nature. The marketing campaign achieved a relatively low level of interest for both sale and lease. There were two genuine enquiries to purchase. Both potential buyers were property developers. One withdrew interest due to the limitations of the heritage listing of the building and the other potential buyer did not proceed after investigations into the current earthquake status and upgrade requirements.

15. There were more enquiries to lease. However, these prospects are unlikely to sustain a market rental. The activities of the prospective lessees that viewed the property included;

    - Children's playground
    - Go karting
    - Skate park

16. The children's playground stated the building design would not work with their requirements due to the central column supports. The skate park lessee thought the back warehouse was suitable however the front warehouse (original heritage building) would not be suitable. There has been no further interest from these parties.

17. The property remains available for sale or lease and is still actively marketed on the internet and a large sign is still in place at the property.

18. There have been 3,877 online inspections of this property across five separate websites.

Assessment of potential sale or lease of the building

19. The prospects of selling the building are very limited. We have been advertising the building for sale for over 12 months. There is very limited enquiry. The limitations with what can be done to the building directly affects the ability to lease or sell the property.

20. As noted earlier, we have had just two genuine enquiries during the previous 12 months. Both were from developers. Their enquiries did not proceed beyond preliminary investigations. One withdrew their interest once they were informed of the classification of the building while the other withdrew because they would not be able to get financial return due to the low earthquake rating and prohibitive costs to upgrade.

21. Based on the Harrisons' costing of $2,630,000 to upgrade the building to code plus original purchase price of $800,000, this equates a total development cost of $3,430,000 prior to other indirect costs like holding costs; rates, insurance, project management, legal, consultants.

22. In my opinion no business would be prepared to tenant this building based on the rental that would be required to achieve a fair return on the cost of development. Due to the high cost of development, a commercial return on the upgrade of this building would not be achievable in comparison to market rates. We have calculated a market return on the development of the property at acceptable market rates achieved within the Ashburton commercial property sector. We have also added a developer's margin of 15% which is reflective of indirect costs of leasing, marketing, holding costs and vacancy allowance. A portion of this property is also leasehold which is not reflected in the property purchase price. The current Glasgow lease provides for a ground rental which is reviewed every 21 years and the current contract rental for the ground lease of $8,890 set in January 2000. We consider the market ground rent would be more in line with $36,000 per annum based on our assessment below.

Existing ground rent	$8,890 per annum
Estimated unencumbered freehold land value	
1,014 @ $600 /m2 =	$608,400
Say:	$600,000
Assessed market ground rental	
$600,000 @ 6.00% /m2 =	$36,000

23. Therefore, based on return on purchase price, capital costs and the accompanying ground rent, a return on cost we consider to be within the below range;

<u>Development Cost</u>	
Purchase	$800,000
Building upgrade	$2,630,000
Developer margin @ 15%	$514,500
Total Development cost	$3,944,500

Rental on development cost @ 7.0%	$276,115 p.a.
Plus market ground rent	$36,000 p.a.
Total rental	$312,115 p.a.
Rental per month	$26,010 p.m.
Plus outgoing allowance	$4,458 p.m.
Total gross rental per month	$30,468 p.m.

Rental on development cost @ 7.5%	$295,838 p.a.
Plus market ground rent	$36,000 p.a.
Total rental	$331,838 p.a.
Rental per month	$27,653 p.m.
Plus outgoing allowance	$4,458 p.m.
Total gross rental per month	$32,111 p.m.

All figures excluding GST

24. Based on the required return the mid-point rental analyses as follows;

<u>Required Rental Analysis</u>	
Adopt rental mid point	$322,000 p.a.
Building Area	1485.7 m2
Rental per square meter	$216.73 /m2

25. Other net rentals being achieved on West Street within the Ashburton market for bulk retail greater than 1,000m² range from $102/m² to $152/m² per annum. The majority of bulk retail premises greater than 1,000m² achieve rentals at the lower end of the range.

26. The required rental of $216.73/m² is some 49.0% to 112% above other rentals within the market. We consider the subject property if converted would be an inferior retail premise upon completion due to building design and central column supports. The building design would be problematic for retail or other alternative uses. Therefore in reality the rental likely to be achieved would be at the lower end of the market range due to these limitations. The high associated cost of the building upgrade is such that it would not be financially feasible to convert. In my opinion if a conversion to upgrade simply for bulk retail was undertaken there would be a significant financial loss.

27. When considering the conversion of this property to bulk retail based on an anticipated market rental at $130/m^2$ which is the mid-point of the market range less a rental attributed to the leasehold car park derives a net rental associated with the building. The likely market rental achievable capitalises to a value less than the development costs therefore incurring a loss. This methodology indicating a development loss.

Market Rental as Bulk Retail say;	
1485.7 m2 @ $130 /m2 =	$193,141
less market ground rent	$36,000
Net building rental	$157,141
Adopt market mid point capitalisation	
@ 7.25% =	$2,095,213
Property Value as retail on completion of conversion say:	$2,095,000
Less original purchase cost	$800,000
Less Building upgrade cost	$2,630,000
Net Loss	-$1,335,000

28. I consider that an alternative conversion to offices would prove to be just as problematic. The office market is very competitive at present with a reasonable supply of vacant premises.

29. I do not consider a tenant would lease the building due to the required rental return on development costs being significantly above market rates as discussed above. A tenant could lease an alternative property which is currently available on the market or a purpose-built premise which could be developed at a lower cost, designed for purpose and with greater flexibility of use and floor layout, lower overheads, and at a lower rental.

30. There is currently no bulk retail premises left within the Ashburton market at the rental level required in my opinion, a rental at this level is unsustainable in the Ashburton commercial property market.

31. If a tenant did require Redmond Retail Limited to incentivise the tenant with a contribution to fit out, this would not significantly change the economics for leasing the building. Any incentive would generally need to be recovered by way of additional lease term or rental. Examples of this have occurred within Ashburton where the landlord has provided $100,000 cash contribution to the fit out. This has been recovered with a higher than market rental being achieved at the commencement of the lease. The incentive has been recovered over the initial term of the lease.

32. The fit out for a specific tenant could vary considerably. At a guide based on the total gross building floor area of 1,485.7m^2 the following fit out would be realistic;

- Retail $527,000 ($335/m^2)
- Office $1,144,000 ($770/m^2)
- Hospitality $1,634,000 ($1,100/m^2) and upwards

The "Gilkison proposal"

33. I have been informed by the company's legal counsel of the so-called "Gilkison proposal" which as I understand it involves the removal of the rear extension to the building, the side additions, and the changes to the West Street façade that were undertaken sometime around the 1950s or 1960s.

34. From my perspective as a valuer and commercial property agent, the issues that arise from this proposal in terms of attempting to retain the building and make a financial return of some kind are:

    a. Whether the retention of the original heritage building alone could generate a financial return through rental that would be sufficient to cover the estimated costs of demolition, strengthening and refurbishment required by this proposal as estimated in the QS report of Mr Harrison of $1,990,919 (paragraph 27).

    b. If not, is the site appropriate in terms of location, size and dimensions to build a new extension to the building to enable a reasonable economic return of the overall site?

35. In terms of the first issue the economics of the property are further reduced with the reduction in building size. The market rentals achievable would reduce accordingly to the reduction in the building size. The cost associated with this proposal is more than proportionally higher than the cost to upgrade the entire building.

36. In terms of the second issue I do not see how a new build extension would work with the existing building design due to the obsolescence and design limitations on an alternative use. Furthermore the high cost associated with the obsolete building will affect the economic viability of any new build extension.

Section 85 requirements

37. I have also been informed by the company's legal counsel that the tests in section 85 of the Resource Management Act require the court to be satisfied that the heritage listing of the Cates building renders it incapable of reasonable use and also places an unfair and unreasonable burden on the company as the owner of the building.

Incapable of reasonable use

38. The cost of the building upgrade works are not economic as it is too expensive if a reasonable return on investment is required from the market. In my view a tenant would not consider leasing this property for development. There will be better alternatives at a

lower rental within the market. The cost associated with the Gilkison proposal is more than proportionally higher and therefore even less financially viable.

39. Any lease of the premise in the market would need to be consistent or competitive with other commercial property. Based on the Harrisons' cost estimates the building upgrade is prohibitive to achieve a return. The market rental level will determine the value of the property if upgraded or converted for alternative use. The current market rental is substantially below a viable return on the cost of the proposed upgrade and therefore a financial loss on development would occur.

40. A financial modelling outlined in paragraph 5 indicates a financial loss would be in the vicinity of $1,335,000 plus other indirect costs. The financial loss for the Gilkison proposal would be even greater due to the higher proportion of costs required over a smaller building floor area. As such, any use would involve a significant financial loss even if a tenant or purchaser could be found. We have not been able to achieve this outcome over the last 12 months of active marketing of the property. This supports my conclusion that there is no reasonable use for this building within the Ashburton commercial property market.

<u>Unfair and unreasonable burden</u>

41. The cost of upgrading this building to be fit for use would be the same for the current owner or any alternative owner. Any real estate sales person facilitating a sale in a market has a duty of disclosure of any known defects with a property and therefore any prudent and informed purchaser would find themselves with the same issues. Therefore we do not consider there to be a market to sell this property.

42. In my view there are very few options available for the use of this property.

43. The cost of strengthening and refurbishing the entire building amount to $2,630,381; and the cost of the Gilkison proposal to maintain and reinstate the original building is $1,990,919. With the limited return achievable on investing in this property it would be more financially beneficial to lock the doors and walk away from this property and invest in an alternative. The loss of the purchase price and holding costs to date to simply leave the building and its current untenanted state and allow it to deteriorate to the point of becoming derelict and beyond the point of restoration would result in a smaller loss than the estimated costs of strengthening and refurbishing the building to enable a change of use that all market indications suggests there is no demand for.

44. In my experience the only realistic available use would be as a secondary storage facility. This use would be for the short term until the building condition deteriorates or the use becomes prohibited under the Building (Earthquake-prone Buildings) Amendment Act 2016.

Conclusion

45. In my view the building is obsolete in design and use. The cost to earthquake strengthen and refurbish the building are excessive and cannot achieve a return within the Ashburton market. Any proposed development incorporating the existing heritage building is cost prohibitive and is uneconomic and a loss would be incurred. I consider this building has limited uses and provides an impediment to the land.

Yours faithfully

Clark McLeod