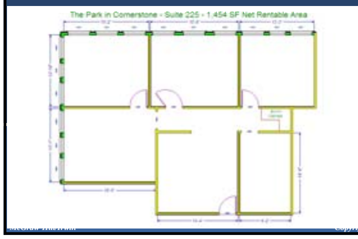
UTSA College of Business:
FIN 4723 Principles of Real Estate Investment

Chapter 22

Leases and Property Types



What is a Lease?

- Legal contract between tenant (lessee) & owner (lessor) for use & possession of RE (land and/or improvements)
- Leases: the "engines" that "drive" values & returns
  - When you purchase a property you are really acquiring a **portfolio of leases**
- Understanding leases is **prerequisite to understanding** commercial RE markets & values

Essential Elements of Lease?

- Long-term lease must contain elements of a valid contract to be enforceable
- In addition, lease must be in writing & contain:
  - a named lessor & lessee
  - adequate description of premises
  - conveyance of premises
  - starting time & length of arrangement
  - negotiated rental rate

Some General Lease Questions

- Who drafts the lease?
- Is there such a thing as a standard office lease or a standard retail lease?
- What is negotiable?

Negotiated Lease Provisions Common to Many Property Types

Allowed Use of Premises

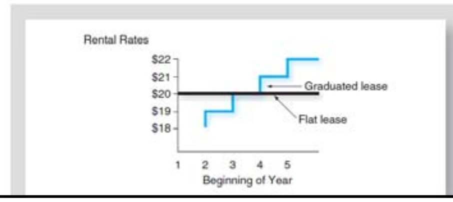
- How can spaced be used and…perhaps… how it can **not** be used by tenant
- Landlord wants?
- Tenant wants?

Lease Term

- One year leases common in residential
- In retail office, and industrial properties, leases may run from 3 years to 20 or more years
- All else equal, longer lease terms:
  - minimize transaction costs
  - provide rental rate security for tenant & owner
  - decrease tenant & owner flexibility

Rental Payments

- Flat rent
- Graduated/escalated rent
  - Rent bumps/escalations are specified in lease
- Indexed rent
  - Rent increases are tied to, say, the CPI

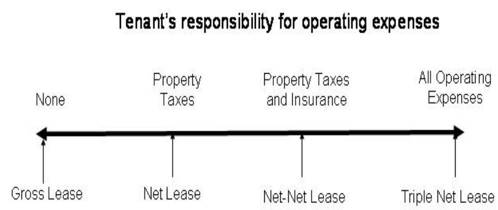


Responsibility for Operating Expenses

- An important question:
  - Does landlord or tenant(s) pay operating expenses?
- May depend on whether lease is a
  - gross,
  - net,
  - net-net, or
  - triple net lease

Web Tip
http://www.cfcre.com/glossary.htm
A dictionary of commercial leasing terms

Responsibility for Operating Expenses



General definitions but…don't trust these terms, must examine the actual clauses in a particular lease

Responsibility for Operating Expenses

- Expense reimbursement revenue
  - If tenant is responsible for some of, or all, operating expenses, according to lease they may:
    - pay them directly (typical in single-tenant properties)
    - reimburse landlord (typical in multi-tenant properties)
- Reimbursements show up in investment CF pro forma as **expense reimbursement revenue**
  - in addition to showing up as operating expenses

Responsibility for Operating Expenses

- How are reimbursable expenses allocated among tenants?
  - In retail:
    - Generally prorated based on **gross leased area** (GLA) of store as % of GLA of entire center
      - According to BOMA: "computed by measuring from the building line in the case of street frontages, and from the inner surface of other outer building walls, and from the inner surface of corridor and other permanent partitions, and to the center of partitions that separate the premises from adjoining shop areas"

Responsibility for Operating Expenses

- How are reimbursable expenses allocated among tenants?
  - In office:
    - prorated based on tenant's **rentable area** as % of total rentable area in building
      - Rentable includes tenant's prorata share of common areas

Responsibility for Operating Expenses

- How are reimbursable expenses allocated among tenants?
  - In multi-tenant industrial properties:
    - prorated based on tenant's **rentable area** as % of total rentable area in building
      - Rentable area includes tenant's exclusive area, plus prorata share of building common areas

Other Negotiated Lease Provisions

- Rent concessions/abatements
  - Including **tenant improvement (TI)** allowances
- Acceptance of premises
  - Tenants have specific time period (one week?) to notify landlord (in writing) of any "defects"
- Conditions for surrender of premises
  - "broom clean & in good order & condition"… "reasonable wear & tear"

Other Negotiated Lease Provisions

- Restrictions on alteration or improvements
  - Usually requires prior consent of landlord
    - Landlords want to maintain integrity of building's mechanical, electrical, and structural systems
  - Landlord may require tenant to restore to original configuration & remove trade fixtures & equipment

Other Negotiated Lease Provisions

- Assignment:
  - **All** of tenant's rights & obligations are transferred to another party
- Sublease:
  - **Only a subset** of tenant's rights are transferred to another party
- Property owners can chose to prohibit assignment & subletting

Other Negotiated Lease Provisions

- Responsibility for maintenance of space
  - Office properties: common for landlord to maintain space
  - Retail & industrial properties: common for tenants to be responsible for their premises; landlord performs all maintenance outside tenants' premises

Other Negotiated Lease Provisions

- Use of common areas & facilities (lobbies, rest rooms, parking lots)
- Requirements for obtaining liability insurance
  - Tenant must provide evidence of insurance to landlord upon request
- Method for handling late payments & conditions for surrender of premises

Other Negotiated Lease Provisions

- Advertising and signage
- Subordination and non-disturbance
- Estoppel certificate
  - A prospective lender or purchaser of a commercial property will usually require certificates from tenants stating that the leases
    - are "in full force & effect" or, if not,
    - specifying defaults by landlord

Lease Options

- Contract provisions that give holder the right--but **not** the obligation--to do something
- Tenant options may include:
  - lease renewal options
  - cancellation option
  - expansion options
    - Including right of first refusal on vacant adjacent space
  - relocation options
- Effect of tenant options on negotiated base rent?

Lease Options

- Owner options include:
  - percentage rent
    - owner has call option on tenant sales
  - expense stops
    - owner has put option on expenses
  - lease cancellation option
    - Makes lease callable for owner
- Effect of owner options on negotiated base rent?

Valuing Leases with Options

- Option values depend on the uncertainty of the underlying "state" variable
- Examples of underlying state variables:
  - percentage rent:
    - tenant sales
  - expense stops:
    - operating expense levels
  - renewal option at "old" rental rates:
    - market rental rates

Calculating Effective Rents

- Contract rental rate often conveys limited information about lease
  - either from tenant's or landlord's perspective
- Calculation of "effective" rental rate captures **monetary** aspects of lease
- Allows leases to be compared on a more "apples-to-apples" basis
- Also called equivalent level rent (ELR)

Calculating Effective Rents: Example

- Assume 5-Year lease at $20.00 p.s.f. per year ($1.667 per month) with 18 months free rent
- What is "effective" rent p.s.f.?

22-25

Calculating Effective Rents: Example

- Step 1: Calculate PV of lease (LPV) after concessions

$$LPV = CF_1 + \frac{CF_2}{(1+k)^1} + \frac{CF_3}{(1+k)^2} + \frac{CF_T}{(1+k)^{(T-1)}}$$

- Step 2: Calculate equivalent monthly annuity
- Step 3: Calculate annual ELR

22-26

Equivalent Level Rent (ELR)

Step 1: Calculate PV of lease after concessions

- Assume 10% discount rate & beginning of month payments (i.e. use "BEGIN" mode) (Set Calculator to P/YR=12)
- PV of $1.667 for 60 months = $79.10
  PV(N=60, I/YR=10, PMT=$1.667, FV=0)= 79.10
- PV of $1.667 for 18 months = $27.98
  PV(N=18, I/YR= 10, PMT=1.667, FV= 0) = 27.98
- PV of lease with concession:
  LPV = $79.10 - $27.98 = $51.12

(or use the CF keys)

Equivalent Level Rent (ELR)

Step 2: Calculate Equivalent Monthly Annuity

- Determine monthly fixed payment that has PV equal to PV of lease with concessions
  - Monthly annuity of $1.077 for 60 months has PV of $51.12

  PMT(N=60, I/YR=10, PV=51.12, FV=0) = 1.077

Calculating Effective Rents: Example

Step 3: Calculate annual ELR

- ELR = equivalent monthly annuity x 12
  = $1.077 x 12
  = $12.92

22-29

Calculating Effective Rents: Another Example

- Assumption:
  - 2,000 SF rentable area
  - 4-year triple net lease at $18.00 p.s.f. per year with monthly payments ($1.50 per month)
  - Permanent Tenant improvements **paid by tenant** at lease commencement (that will not be recovered through TI): $40,000
  - 8% discount rate is appropriate
- What is "effective" rent p.s.f.?

22-30

Calculating Effective Rents: Another Example

Step 1: Calculate PV of lease including improvements

- 8% discount rate & beginning of month payments (i.e. use "begin" mode)
- PV of $3,000 ($1.50 x 2,000) for 48 months
  PV(N=48, I/YR=8, PMT=$3,000, FV=0) = $123,705
- PV of $40,000 improvements = $40,000
- PV of lease with improvements:
  LPV = $123,70510 + $40,000 = $163,705

22-31

Calculating Effective Rents: Another Example

Step 2: Calculate Equivalent Monthly Annuity

- Determine monthly fixed payment that has PV equal to PV of lease with improvements
  - Monthly annuity/payment of $3,970 for 48 months has PV of $163,705

PMT(N=48, I/YR=8, PV= -163,705, FV=0) = 3970

22-32

Calculating Effective Rents: Another Example

Step 3: Calculate annual ELR

- ELR = (equivalent monthly annuity x 12)/SF
  = ($3,970 x 12)/2,000
  = $23.82/SF

In other words the tenant would be indifferent between the deal he or she has with you, and doing uncompensated TI, or with paying $23.82 rent for a space for which no unreimbursed TI is required.

22-33

Broader Lease Considerations Not Captured in Effective Rent Calc.

- Interlease risk
  - In ELR calculation, tenant's discount rate reflects only risk of lease in question
  - However:
    - expected tenancy often longer than current lease term, &
    - expected rent pmts **beyond** existing lease are more risky than those **within** a lease
  - Thus, longer-term leases reduce risk
    - not reflected in ELR calculation

22-34

Broader Lease Considerations Not Captured in Effective Rent Calc.

- Releasing costs
  - Examples:
    - vacancy period
      - owner loses revenue
    - search costs
      - owner pays leasing commissions
      - both use valuable time
    - tenant pays moving expenses
    - owner pays more TI's

22-35

Broader Lease Considerations Not Captured in Effective Rent Calc.

- Releasing costs
  - Owner & tenant both negatively affected by releasing costs.
  - Implication:
    - Both prefer longer lease terms--all else equal

22-36

Broader Lease Considerations Not Captured in Effective Rent Calc.

- Flexibility
  - Tenant's uncertainty about future space needs
  - Owner's desire to alter mix of tenants in a dynamic rental market
  - Implications:
    - Flexibility considerations suggest **shorter** term leases are more valuable to both

22-37

Summary of Effects of Broader Cons. on Preferred Lease Term

	Impact on Preferred Lease Term for	
Consideration	Tenant	Owner
Interlease Risk	Longer	Longer
Releasing Costs	Longer	Longer
Flexibility	Shorter	Shorter

All three are ignored in effective rent calculation

22-38

Office Properties and Leases

- Class A Properties:
  - Commands highest rents because they are most prestigious in their tenancy, location, & overall desirability
  - Usually newer structures
  - Typically owned by institutional investors
  - About $25 Quoted rent for San Antonio ($21 is average for all office in SA)

22-39

Office Properties and Leases

- Class B:
  - Rents usually less than Class A buildings because of a less desirable location; fewer amenities; less impressive lobbies, elevators, etc. ($20)
- Class C:
  - Usually once Class A or B
  - Are older & reasonably well maintained
  - But are below current standards for one or more reasons ($16)

22-40

Measuring Rentable & Usable Space in Office Blds: BOMA Standards

- Rentable area:

  = gross area - "vertical penetrations"
- Usable area:

  = rentable area - common areas

  (e.g. conference rooms, lobbies, etc.)

22-41

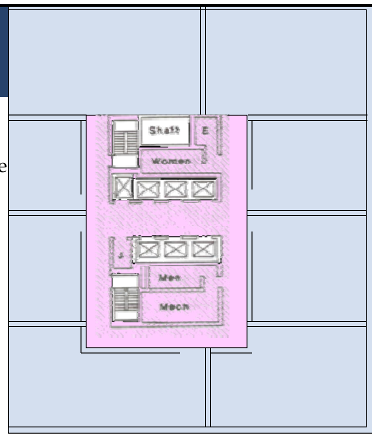
Measuring Rentable & Usable Space in Office Blds: BOMA Standards

- Rent generally quoted on **rentable area**
- Tenant's pro rata share of common area:

  = tenant's usable area / total usable area

22-42

- Rentable Area
  All the space to the outside of the exterior walls, except vertical penetrations



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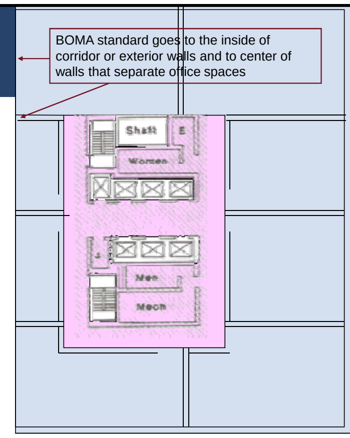
- Usable Area
  Rentable area less the public spaces & circulation areas (common areas)



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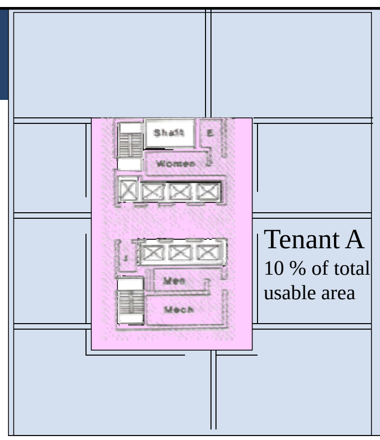
- Tenant's Rentable Area = sum of
  Tenant's portion of usable area
  + pro rata share of common area



22-45

Rentable Area Example

- Total usable area: 16,000 s.f.
- Total common area: 2,000 s.f.
- Total rentable area: 18,000
- Tenant A's usable area: 4,000 s.f.
- What is tenant A's rentable area?

22-46

Solution: Rentable Area Example

$$\begin{aligned} &\textit{tenant's rentable s.f.} \\ &= 4{,}000\, s.f. + \left(\frac{4{,}000\, s.f.}{16{,}000\, s.f.}\right) x\ 2{,}000\, s.f. \\ &= 4{,}000 + (0.25)\ x\ 2{,}000 \\ &= 4{,}000\, s.f. + 500\, s.f. \\ &= 4{,}500\, s.f. \end{aligned}$$

- 500 s.f. is the "load factor"

22-47

Expense "Stops"
Common Source of Expense Reimbursement Revenue

- Common in office leases
- Owner responsible for OE's up to (**"stop"**) amount
  - stated as amount/SF of total building rentable space

22-48

Expense "Stops"
Common Source of Expense Reimbursement Revenue

- Per SF expenses **beyond** stop passed through based on tenants' prorata share of building's rentable space
- Tenants may have different $/s.f. stops
  - depending on when they signed leases & on their negotiating position

22-49

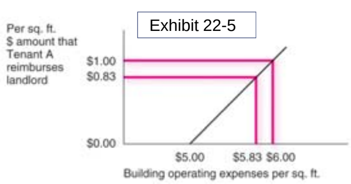
Expense Stop: Example

- Assume owner recovers all OE's from tenant except management & administrative expenses
- Total rentable area is 60,000 s.f.
- Total recoverable OE's are $350,000 (or $5.83/s.f.) in example year ($350,000/60,000)
- Tenant A's rentable area is 6,200 s.f. & expense stop is $5.0/s.f.

22-50

Example:
Tenant A's lease has $5.00 per SF expense stop: building operating expenses for the year are $5.83 per SF

- Owner recovers $5,146 from tenant A [$5.83 - $5.00) x 6,200]
- A new tenant with a "base-year" stop would have a $5.83/s.f. stop



22-51

"Base Year" Expense Stops

- Total recoverable OE's in this year are $350,000 (or $5.83/s.f.)
- New tenant's with base-year stops would have $5.83/s.f. expense stops

22-52

Retail Properties and Leases

- Neighborhood or "strip" center
  - Located for convenience of a close-by resident population
  - Contains retail establishments offering mostly convenience goods (e.g., groceries) & services (e.g., barber shop, video rental, & dry cleaning)
  - Often "anchored" by chain grocery store
  - Gross leasable area of anchor(s) & non-anchored tenant space is approximately 50,000 square feet
  - Trade area: typically 2-3 mile radius of center

22-53

Retail Properties and Leases

- Community center
  - Larger version of a neighborhood center
    - GLA is usually three times that of a neighborhood center
  - Often anchored by a discount department store
  - May include clothing stores, banks, furniture stores, lawn & garden, fast food operations, & professional offices (e.g., dentists)
  - Trade area: usually 3-6 mile radius of center.

22-54

Retail Properties and Leases

- Power center
  - Dominating feature is high ratio of anchors to ancillary tenants
  - Typically contain three or more giants in hard goods retailing (toys, electronics, home furnishings, etc.)
    - Home Depot & Wal-Mart, etc.
  - Draw shoppers from a radius of 5 miles or more

22-55

Retail Properties and Leases

- Regional centers:
  - Focused on general merchandise
  - Usually at least two anchor tenants that are major department stores (e.g., J.C. Penney's)
  - At least 200,000 square feet of GLA devoted to nonanchor tenants.
  - Draw people from larger area than neighborhood or community centers, although 80% of sales are drawn from within 10-mile radius.
  - Contain several stores of one type (for example, shoe stores)
  - Many include fast-food outlets arranged in food courts

22-56

Retail Properties and Leases

- Super-regional malls:
  - May have as many as five or six major tenants & hundreds of minor tenants.
  - Typical size is 1 million square feet, but many exceed 2 million square feet of leasable area
  - E.g. Houston Galleria – 5 anchors with 2.4 million square feet, with about 375 stores (developed by Gerald D. Hines and owned by Simon Property Group)

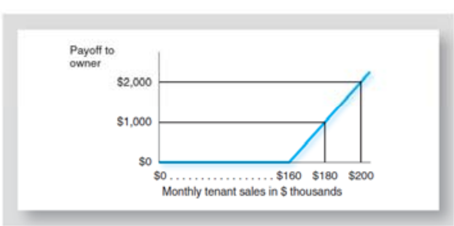
22-57

Negotiated Lease Provisions: Retail

- Percentage rent
  - With clause, total rent = base rent + percentage rent
  - Example:
    - Base rent: $96,000 per year ($8,000/mth)
    - 5% of gross sales in excess of $160,000 is paid as percentage rent
    - Store produces $200K in monthly gross sales; total rent is $8,000 + 0.05($200,000-$160,000) = $10,000
  - Effect of this clause on minimum (base) rent?

22-58

Percentage Rent Example Illustrated



22-59

Negotiated Lease Provisions: Retail

- Tenant usually must provide
  - monthly sales reports: detailed info on tenant sales
  - financial statements upon request
- Advertising
  - Landlords want tenants to advertise
    - Spend a minimum % of gross sales on advertising
      - Hard to monitor
    - Require tenant to advertise in a minimum # of the shopping center's advertising tabloids

22-60

Negotiated Lease Provisions: Retail

- Restrictions on operation of tenant's business & landlord's remedies
  - Common in retail
    - Tenant must be open for business during business hours of center…or pay additional rent
- Cancellation option for tenant
  - May be granted if center is struggling to sign tenants
  - Co-tenancy provision
    - Tenant allowed to pay only percentage rent or cancel if one or more anchor tenants vacate

22-61

Negotiated Lease Provisions: Retail

- Exclusive use
  - Grants tenant sole right to sell a specific product or service in center
  - Why do landlords dislike this provision?
- Parking
  - Landlord requires tenant employees to park in designated areas
  - Saves "prime" spots for customers

22-62

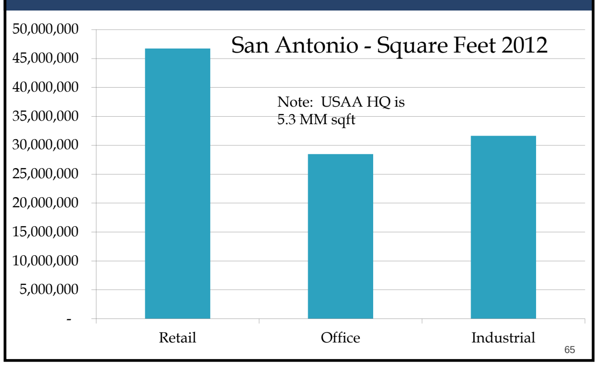
Negotiated Lease Provisions: Retail

- Radius
  - Prohibits tenant from opening another store nearby
  - Protects landlord's percentage rent
- Signage
  - Major negotiations often ensue over placement and size of tenant's signage

22-63

Defining Leasable Area in Retail Properties

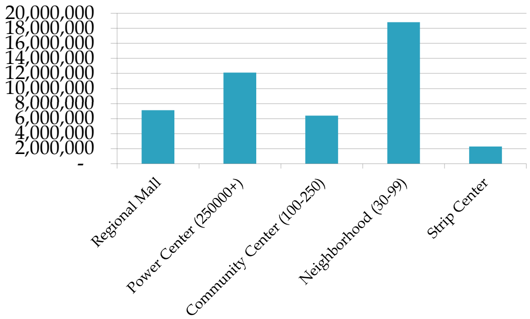
- Rents are quoted on basis of gross leasable area
- GLA is amount of space occupied & controlled by tenant
  - Similar to usable area
- Gross floor area of shopping center is equal to total GLA plus square footage of common areas
- Charges in addition to CAM can be security, advertising, and management of the common areas.



65

66

San Antonio Retail



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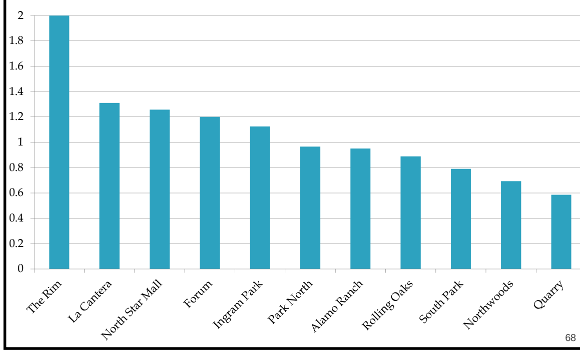

68

End of Chapter 22

22-69