UTSA COB
Fin 5433
Real Estate Investment

Fin 5433

- What is investment?
- Does investment differ from saving?

Investment Considerations

- Return
- Risk
- Taxes
- Liquidity
- Time Horizon

Real vs. Financial Asset

- An asset is something you could sell for a positive amount
- Real asset produces value (real estate, factory, patent)
- Financial asset assigns value produced by real asset to the security holder.
- The bulk of this course will deal with studying the real asset
- REIT's (Real Estate Investment Trust) are a convenient way to hold securitized real estate.

CHAPTER 9

Introduction to Income-Producing Properties:

Leases, Rents, and the Market for Space

Defn: CRE – Commercial Real Estate

Property Types

- Residential
  - Single Family - large asset for individuals – typically receive an implied dividend
  - Multifamily – apartments – more than 4 units
- Nonresidential
  - Commercial
    - Office Buildings
    - Retail
  - Industrial
    - Warehouse Space
    - Manufacturing

Property Types

- Nonresidential (continued)
  - Hotel/Motel
    - One-night stays
    - Destination resorts
  - Recreational
  - Institutional – are real assets, but may not produce a direct financial return
    - Government
    - Hospital
    - University
- Mixed Use – Combined two or more uses – usually residential with retail, office with retail, or residential office and retail.

Supply & Demand

- Equilibrium Rent – May rarely if ever be achieved in RE because the supply of RE at any point in time is fixed.
- Equilibrium Vacancy Rate – Frictional vacancies (natural time between tenants, plus and space held back for strategic purposes
- Short-Run Supply - fixed
- Long-Run Supply – what the market will create given a set of economic opportunities (land cost, construction cost, interest rates, zoning)
- Demand Factors – economic base, employment, population

Location & User-Tenants

- Motivating Factors
  - Increase sales
    - Business type where success requires a higher revenue stream and heavy pedestrian traffic (location location location)
  - Reduce operating costs
    - Business type where success is based on a lower cost structure and large amount of land
    - Explains data centers in San Antonio (also call centers)
  - Clustering and submarkets
    - Similar businesses and operating cost structures locate in similar locations – suppliers to Toyota will tend to cluster near Toyota.
    - Not a lot of clustering in SA, though warehousing clusters at good access points, hotels near vacation destinations. Office buildings are spread into many areas. Retail seeks good traffic locations unless it generates its own traffic.

Popular Business Choice: Leasing

- More cost-effective than owning
  - Space requirements – changes as business grows or shrinks
  - Owning is a heavy capital investment – capital not available to grow the business if tied up in RE
    - HEB is an exception – it likes to own and control space
  - Stay out of the "real estate business"
    - Maintenance and repair
  - Maintain operating flexibility
  - May not have real estate expertise (some have expertise, but choose to lease)
  - May not achieve economies of scale (only want a small space in each mall)
  - Office and retail condo's are not popular

Leasing (con't)

- Estimates:
  - Office Buildings - > 80% leased
  - Industrial approx 60% leased
- Exception – need for specialized space or desire to control location for extended period of time (UTSA leases some office space, but owns most of its real estate)
- Net Result: Specialized real estate firms.
  - Assess needs, develop, own, and manage (or do a subset of these)

Real Estate Income

- Market Rent
  - The outcome of the supply & demand for specific property type and location
  - Real estate as an asset may be much more durable than its its market (lots of nice old houses and buildings in MI)
  - Depends on:
    - Population demographics & income level – first comes people, then real estate to meet needs (apartments, single family houses, offices and retail). Rents are higher in NYC than in SA.
    - Economic base of the area
    - Economic forecasts

Vacancy

- It's impossible to have just the right amount of real estate
- Some vacancy is frictional
- Some vacancy is new space waiting for its first tenants
  - Absorption is the term for the rate at which vacant space becomes occupied
- Some vacancy is due to shifting demands for space and the aging of real estate
- Some vacancy if strategic (HEB won't lease space at NW Military and Huebner to a competitor)
- An important part of a proforma as vacancy affects value

Leases – Occupancy Property Right

- Lessor-Owner, Lessee-Tenant
- The lease is a major input into estimating the cash flows from a property (other inputs regard costs)
- The lease is an asset for the owner and liability for the tenant
- Qualify the tenant – underwriting
  - Financial capacity
  - Stability of market or business
  - Third party guarentees
  - (Tenant also has to be concerned about the quality of the landlord)

Some Lease Content Items

- Parties, Dates, Length
- Base rent & any adjustments, deposits
- Allowable and prohibited uses and other restrictions
- Which party responsible for what
- Changing of space
- Tenant improvements (dollar allowance, who provides, what happens at end of lease)
- Subletting
- Use of common areas
- Services to be provided
- Eminent domain or fire or other losses
- Termination or renewal notice

Possible Lease Features used to determine income

- Base Rent and how changes in rent will be determined
  - Initial rent
  - Free rent
- Flat Rent Leases
  - No rent change over lease term (apartments typically)
- Step Up Leases
  - Specified rent increases at specified times
- Indexed Leases
  - Periodic rent adjustment-CPI Index (though may contain caps)
- Percentage Lease
  - Rent partially based on sales (used for retail)
  - Overage Rent (extra rent once certain sales targets are achieved)

Leases & Expenses

- Renewal options
- Typical Operating Expenses
  - Cleaning, repairs, maintenance, landscaping, utilities, security, management, property taxes, insurance
- Gross Lease
  - Tenant pays rent only with the property owner paying all operating expenses
- Modified Full Service Lease
  - Tenant pays rent & specified expenses (if the tenant is a high electricity user, for example, will want to consider this in designing the lease)

Leases & Expenses

- Expense Stops
  - Tenant pays rent plus some pro-rated operating expenses above the "stop" level (e.g. $5/ft^2).
  - Determined on a rentable square foot area
- Pass-Through Leases
  - Some or all of expenses paid by tenant
  - Net – operating expenses passed through to tenant
  - Net-Net – Op exp, plus property taxes and Insurances passed through
  - Net-Net-Net (Triple Net) – maintenance, repairs, and building alterations passed through (in addition to above)
- Combinations

Effective Rent

- Used to compare different leases
  - Adjust for free rent
  - Compute present value of rent stream
  - Convert present value to an equivalent annual annuity
- Example 9-1:
- Consider the following rent schedule
  - Year 1 = $12/square foot
  - Year 2 = $14/square foot
  - Year 3 = $15/square foot
- If the interest rate is 12%...

Effective Rent

- Step 1: Compute the present value

C0 = 0
C1 = 12
C2 = 14
C3 = 15
i = 12

CPT NPV = $32.55

Effective Rent

- Step 2:

PV = $32.55
n = 3
i = 12

CPT PMT = $13.55

This is the effective rent for this rent schedule – also referred in finance to the equal annual equivalent.

Effective Rent

- Use the same procedure to evaluate all potential lease alternatives.
- This measures the return to the lessor and cost to the lessee.
- Effective rent is typically less than quoted rent in a soft market due to concessions such as free rent. While quoted rent is easily found, effective rent is not easily determined as most leases are private documents.
- See Exhibit 9-7, page 265

Pro-Forma Cash Flow Statement

Warning: Although pro-forma's have a similar look, one has be tuned to the differences that may exist

Rental Income
+ Other Income
+ Recovery of Expenses
- Vacancy & Collections
- Concessions

Effective Gross Income (EGI)

Pro-Forma Cash Flow Statement

EGI
- Operating Expenses

Cash Flow from Operations (NOI)
- Lease Commissions
- Recurring Capital Outlays
- Nonrecurring Capital Outlays

Net Cash Flow

Above versus below line NOI

- Above line NOI refers to the case when capital costs and similar items are taken out before getting to the NOI
- Below line NOI refers to when these costs are taken out after quoting the NOI
- NOI and Cash Flow from Operations are used interchangeably in this text.
- Above line NOI would be the Net Cash Flow from the example above.
- Net Cash Flow is the income the building produces

Gross Building Area v. Rentable Area

- A single tenant, if renting the whole building in a sense rents the gross building area
  - Includes stairwells, elevator, walls, service closets
  - Lease could be based on rentable area which does not include these "unused" portions. Definition of **rentable area** can be local. **Usable area** is the area the tenant occupies.
  - Building efficiency is sometimes measured as the ratio of rentable to gross area
- When there are multiple tenants, each only wants to pay rent for the part occupied. This is the usable area. The rentable area will also include a portion of shared area such as the lobby and restrooms and elevator landings

Load Factor

- Consider a 20,000 square foot floor, with four 4500 square foot usable spaces with the remaining 2,000 square feet common areas. The landlord will prorate the useable area to the rentable are via a load factor.

$$LoadFactor(perfloor) = \frac{RentableArea(perfloor)}{UsableArea(perfloor)}$$

$$1.111 = \frac{20,000}{18,000}$$

- So a tenant with 4,500 square feet of usable area, would pay rent based on a rentable area of 4,500 * 1.111 = 5,000 square feet.
- Other prorations such as for the main lobby may also be required, including an additional load factor.
- Expenses will also depend on costs for common areas.

Office Leases

- Normally 3-7 Year Terms
- Renewal option
- Premium Rents (First floor, or view, near elevator, corner)
- Rent Discounts (Opposite of above, plus discontiguous space)
- Right of first refusal as adjacent space becomes available
- Right to put back space
- Purchase option
- If a major tenant, the right to approve other lessors
- Parking
- Signage

Industrial Property Leases

- Similar to office leases
- Individualized and longer
- Tend to be pass-through (some type of net lease)
- Premiums & Discounts based on location and traffic flow

Retail Leases

- Sales per Square Foot drives the value of the property
- Provisions on operations
- Limits on Other Tenants
- Anchor (e.g. Macy's) and In-Line Tenants (e.g. Apple Store)
  - Rent Differences (Anchor tenants low rates)
  - Anchor tenant may own its space with operating agreement
- Common Area Maintenance (CAM) – different for Anchor and In-Line
- Percentage rents may be common for In-Line Tenants (effect of employee sales, internet sales, returns, gift certificates?)
- Kick out clause – for unsuccessful merchants
- Co-tenancy clause – In-Line may leave if Anchor does.

Apartment Leases

- Shorter Term – turnover costs
- Consumer protection laws
- Gross Potential Rental Income
  - Full occupancy
- Loss to Lease – some units with old contracts can be rented at a rate lower than current market, so an adjustment on the proforma is need. (Could be an addition in a declining market).
- Other income from vending, laundry, clubhouse rentals, cable TV