

Raising Your Commercial IQ Webinar

Office, Industrial and Retail Leasing

Neil Osborne M.B.A.
DL. (604) 988-9964
nosborne@investitsoftware.com
Investit Software Inc.
Toll free 877-878-1828
North Vancouver BC
Canada
www.investitacademy.com
investit@investitsoftware.com
www.investitpro.com
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Table of Contents

Objectives	5
Landlords & Tenants	6
Landlords	6
Tenant	6
Leasing Characteristic by Property Types	7
Shopping Centers	7
Retail Strips	7
Industrial	8
Office Buildings	9
Recommendations	9
The Leasing Process and Documents	9
Types of Leases	13
Modified Gross Lease	13
Indexed Gross Lease or Gross Lease with an escalation clause	13
Triple Net Lease (NNN) or Net Lease	13
Expense Stops and Base Year	13
Setting the Stop	14
Expense Caps	14
Rent Cap	14
Types of Rent	14
Basic Rent	14
Additional Rent	14
Free Rent	14
Percentage Rent (Shopping Centers)	15
Natural Breakpoint	15
Artificial Breakpoint	15
Rentable Areas	16
Rentable Area	16
Usable Area	16
Which area and how will it be measured?	16
Measuring Office Buildings using the BOMA Standards	17
Measuring Retail and industrial buildings	18
Flex Space Buildings	18
Who will do the measuring?	18
Leasing new space	19
Tenant Improvements (TI's) & Build outs	21
Shell Lease	21
Turnkey Lease	21
Construction Cost Overruns	22
Recovering Tenant Improvement (TI's)	22
Completion Date & Occupancy	23
Force Majeure	24
Completion Date & Occupancy	24
The Tenant "Nightmare"	24
Remedies for late delivery by the landlord	24
Establishing the "Bump or "Step" or "Renewal Rate"	25
Establishing comparable lease rates	26
Assignment	27
Sublease	27
Tenant Profiting of Subletting	27
Operating Expenses & Recoverable Expenses	28
Definition of Operating Expenses	28
Pro-rata Share of Operating Expenses	28
Grossing-Up Operating Expenses	29
Example. Pro-rata Share of Property Taxes	30
Renovating and Subdividing Space. Issues	31

Load bearing and shear walls systems	31
Lease Comparison Analysis	34
Case Study: Space comparison example	35
Lease Comparison Example	37
Lease Negotiations. Trade Offs between Landlord & Tenant	41
Case Study. Lease negotiations. Landlord Perspective	46
Valuing Land or Ground Leases.....	49
Blending & Extending Leases.....	51
The impact of a lease on value and marketability	52
Tips for reading a lease	54
Demolition clause	56
Developing a Leasing Career.....	57
Building Your Support Team. Case study	57
Tips for Leasing Space.....	58
Advantages of Leasing as a Career	58
Analyzing Mutually Exclusive Investments.....	59
Analyzing Buying versus Renting a home. Case Study	59
Buy versus Lease Analysis. Case Study	61
Buy versus Lease Crossover Graph	64
Lease Abstract	66
Information Sources and web sites	67
Leasing Terms and Definitions.....	68
Know Your Property Types: Industrial Property.....	73
Know Your Property Types: Retail Property	75

Objectives

To provide a comprehensive understanding of,

- the leasing process
- the terms used in leasing
- how to read a lease and what to look for in a lease
- the differences between the different kinds of leasing markets
- how tenants go about choosing a location and space
- what question to ask the landlord and tenant
- some of the complex issues involved in a lease
- why leases are often complex, lengthy documents
- how to carry out a lease comparison analysis
- how leases impact the value of a property and the available financing

Enable you to deal confidently and knowledgeably with landlords, tenants and lawyers.

Help you decide if leasing is an attractive career choice.

Landlords & Tenants

Landlords

The “Lessor”

Landlords range from those who are naïve and doing their first lease to very experienced landlords. Because of their knowledge, an experienced landlord is easier to work with than a new landlord.

Be very careful when working with an inexperienced landlord because of the potential for misunderstanding. As an example, what “Free Rent” or “Rentable Area” and “Usable Area” means.

Major landlords for office buildings and shopping centers will insist on using their lease and are tough negotiators.

The landlord’s major concerns are;

1. To maintain and enhance the value of their property
2. Concerned about the lender and future financing
3. That the tenants are compatible
4. The creditworthiness of the tenant
5. Length of the lease. Re-leasing can very costly

Tenant

The “Lessee”. Range from being extremely naïve to very experienced

Representatives of national organizations, banks, franchises, etc. will insist on using their leases. Tough, knowledgeable and experienced negotiators.

Naïve tenants. First lease. Tread carefully and explain the key points in great detail to avoid misunderstandings. Some examples are;

Example No. 1: Misunderstanding ‘Free Rent’

You tell the tenant they are getting three months Free Rent. They think;

Great. I don’t have to pay anything for the first three months

The reality;

1. The landlord will give one free month each year for three years
2. The landlord wants to be paid the “Additional Rent” or “Recoverable Expenses”

Example No. 2 Misunderstanding the rentable area

The rent is \$15.00 per Sq. Ft. per Yr. The tenant asks “what is the area that they will occupy?” You told me 900 Sq. Ft but didn’t explain that the area is the “Usable Area” and that the Rent will be based on the “Rentable Area” not the “Usable Area”

Tenant calculates the rent as follows;

$\$15 \times 900 = \$13,500$ per year. If the “Load Factor” is 15% the rent is $\$15 \times 900 \times 1.15 = \$15,525$.

TIP: Always quote the rent per month or year to avoid any misunderstandings such as \$15,525 per month. This will save all kind of grief.

Tenants are concerned about;

1. Total occupancy costs
2. Neighboring tenants. Prestige may be a concern
3. Linkage to suppliers, customers, waste disposal, etc.
4. Where their employees live, nearness to airports and transportation
5. Nearness to an airport
6. Moving costs
7. Environmental issues and contamination
8. Ability to exit out of the lease

Leasing Characteristic by Property Types

Different types of properties require very different skills and knowledge to be a successful leasing agent.

Shopping Centers

The landlord is concerned about tenant mix and compatibility and seeks synergy between the tenants where the sum is greater than the parts. The lease tightly controls the tenant activities, leasehold improvements, and what products they can and can't sell and whether they can operate another store within a certain radius of the mall.

Shopping center leases are massive and extremely complex. Landlords don't like to negotiate unless you're the anchor tenant. It's my way or the highway.

Rarely can a local retailer obtain space in a regional shopping center. They favor national or large local chains.

It's very unlikely you will have the opportunity to be involved in a regional shopping center lease.

Retail Strips

The landlords are more flexible and easier to work with than regional mall landlords.

The major concern is tenant compatibility and the creditworthiness of the tenant

Example of poor tenant mix and lack of synergy.

Strip Shopping Center

Highly congested apartment area. Virtually no street parking and parking for 10 cars on the site

Poor Tenant Mix

Seven-Eleven (In and out)

Japanese restaurant (Stay)

Vietnamese Restaurant (Stay)

Baskin & Robbins (In and out)

Pizza Place (In and out)

The restaurant ties up the parking making access to the Seven-Eleven and other stores difficult.

You need to understand why retailers locate where they do and how they go about choosing a location that is generally based on demographics, shopping behavior, and competitors as well as occupancy costs.

Examples of retailers locating based on shopping behavior:

Furniture, car dealership, art galleries cluster because they know people “Shop” for their products
 Dry cleaners, bakeries, etc. locate near supermarkets
 and Star Bucks locates everywhere!

Industrial

Very specialized, technical area of leasing

Different types of electrical systems. Three-phase star or delta electrical systems

Floor load capacities

Ceiling heights and volume

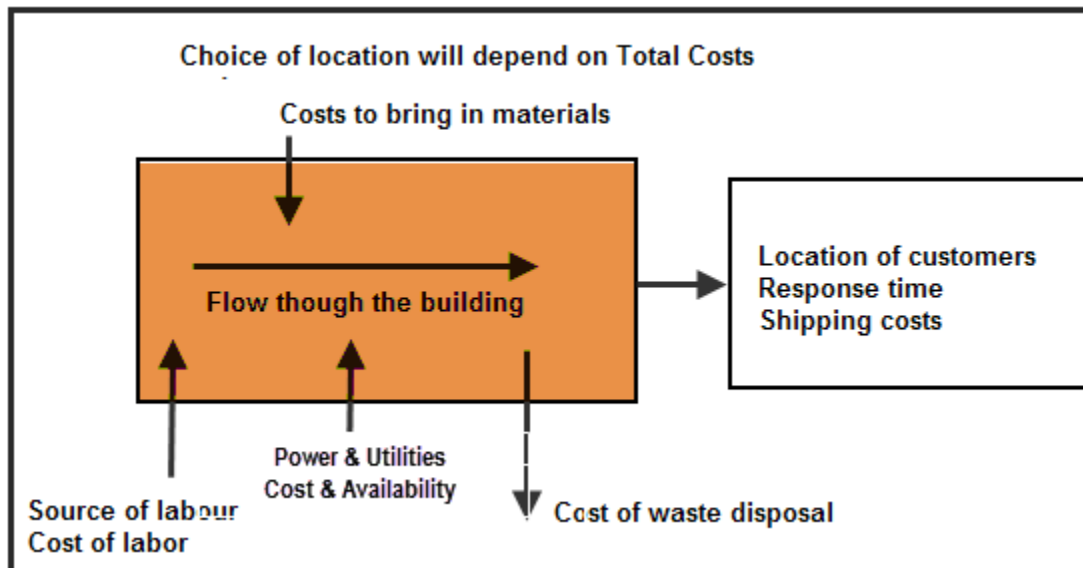
Distance between columns

Major retrofits, leasehold improvements and rewiring of the premises are often involved

Types of loading docks and rail access

Tenants may be concerned about the flow of their materials and goods through the warehouse. As an example, the relationship between the loading and unloading areas.

The cost of leasing is only one part of the total operating costs. In deciding on a location they will look at the “Total Cost” and involve a diverse team comprising engineers, distribution managers, human resource staff, accountants, etc. Computer models may assist in the decision.



Office Buildings

Less complex than industrial and regional shopping centers.

Landlords are often willing to negotiate the term of the lease. In large office buildings, the leases can be complex but not nearly as complex as shopping centers. A major issue is the allocation of the operating expenses between tenants.

Recommendations

Specialize by property type and geographic area. Each type of real estate such as retail, office and industrial is very different and requires different knowledge and skills to be successful.

The Leasing Process and Documents

There are four major documents that you will encounter in leasing.

Commission Agreement or Authority to Lease Form

Available from your real estate association or real estate office

The key question is;

- How is the leasing commission calculated?
- How will it be paid?
- When will it be paid?

Leasing Fee: The method of calculating the leasing fee varies widely and depends on local practices.

Leasing fees can also be paid on renewals. The Leasing Fee is generally calculated on the “Base Rent” and excludes the “Additional Rent” and may or may not provide for a commission on lease renewals.

When will the leasing fee be paid? Called a “trigger clause”. What event triggers the payment of the leasing fee?

- Signing of the “Offer to Lease”
- Signing the lease
- Occupancy

This clause has to be very carefully constructed.

As an example, if the leasing fee is paid on the signing of the lease, what if the “Offer-to-lease” is signed, the tenant moves in but the lease is never signed?

How will the leasing fee be paid? Generally, the full leasing fee is paid when due. However, the landlord may negotiate to have the fee paid monthly over the first term of the lease.

There are 3 major documents used in the leasing process.

1. Letter of Intent
2. Offer to Lease
3. Lease

Letter of Intent

The letter of intent is a proposal from the landlord or the tenant, which spells out the major terms and conditions to see if there is a general agreement. The letter of intent is not a contract.

The advantage of the Letter of Intent is that it is quick to prepare and saves time and legal costs.

If the parties cannot reach a general agreement, the Letter of Intent saves time and perhaps legal costs and is less intimidating than the Offer-to-Lease or Lease.

The Letter of Intent is not a contract. It is simply a letter acknowledging matters discussed and agreed upon between the parties or is a proposal from one party to another.

The following is a brief example of a Letter of Intent.

From: A. Tenant To: A. Landlord

September 1, 2010

Dear Mr. A. Landlord:

Re: Leasing the retail store at 1234 Jones Street, Vancouver, B.C.

I am interested in renting the above space which I understand to be approximately 2,000 square feet for a monthly Basic Rent of \$1,200 per month, for a five year term, which a option to renew for another three years at the market rents prevailing at that time.

The rent will be a net rent and I will pay for all the operating expenses, insurance, and property taxes associated with the above space excluding accounting, administration and property management or depreciation expenses.

I will take occupancy on January 1, 2011 and require a rent free period of two months. During the rent free period there will be no rent paid and no payment for operating expenses incurred by you during the rent free period. You will provide a \$8,000 Leasehold improvement allowance. The first term will commence January 1, 2011

Should you find the above terms and conditions acceptable we should proceed to the "Offer to Lease."

I look forward to your response. Mr. Tenant

You will notice that the rent has been stated as an amount, i.e. \$1,200 per month rather than a rate of \$12 per square foot per year. This approach avoids all the problems associated with how large the area is and how it's will be measured.

Should the Landlord not agree with the above proposal, he or she can present a counter-proposal which may involve changing some of the terms, and perhaps adding new clauses. Perhaps the landlord may counter the proposal by offering a leasehold improvement allowance of \$10,000 payable on occupancy, but increase the Basic Rent to \$1,500 per month.

Offer-to-Lease

An Offer-to-Lease is a contract between the Landlord and the Tenant which spells out the significant terms and conditions of the Lease. It is an interim step prior to the development and execution of the Lease.

Once the Offer-to-Lease has been signed and accepted by both parties it is a contract and enforceable in law and is called the Agreement to Lease.

An accepted Offer-to-Lease, or the more correct term Agreement to Lease, is a contract to execute a Lease. The Offer-to-Lease which precedes the execution of the Lease safeguards the interest of both parties while the lease is being prepared and executed.

The reasons for using an Offer-to-Lease are that it is the interim agreement that precedes an often lengthy and complex Lease document. It enables the parties to contract on the major points such as the Basic Rent, Additional Rent, the term, commencement of the term, etc. To be valid in law, the Offer-to-Lease must have the essential terms and conditions required for an enforceable lease. They are:

1. **The name of the parties.** The names of the individuals or corporations must be identified.
2. **A description of the premise.** It must be clear as to what is being leased. Approximate size (Usable Area) A common practice is to attach a plan as an Addendum to the "Offer-to-Lease" and identify the demise by outlining the boundaries using a colored pen.

3. The Term

The term must be described with certainty. A term to commence when the repairs are complete is not certain. Likewise, the term is for the duration of the war is not clear. The term should be specified using a;

Commencement date
Length of the term
The termination date

And other critical issues such as;

Option to Renew
Tenant Improvement Allowance

The "Offer-to-Lease" should contain all the essential terms of the Lease and may range in size from one or two pages to twenty pages or longer. While it is possible to bypass the Offer-to-Lease and move directly to the execution of the Lease, this is not usually done because the Lease is often a long and complex document that contains a lot of "Boiler Plate" clauses which need to be ironed out by the lawyers. This often takes a long time to complete.

The Boiler Plate clauses are not essential to the lease, but provide long term protection of the parties' interest. Clauses related to insurance would be an example. Some times the Lease is not signed until after the tenant has moved into the property

The Offer-to-Lease approach provides a stepped approach. If a potential tenant is faced directly with a complex Lease at the start of the negotiations they may be reluctant to proceed. Leases can be very intimidating documents. The Letter of Intent and Offer-to-Lease approach helps the parties step through the leasing process by dealing with the essential terms first.

Often a copy of the Lease is attached to the Offer-to-Lease and forms part of the contract. There are two types of leasing contracts.

Partial Consensus

This is a contract that acknowledges that certain items still have to be agreed upon. If the Offer-to-Lease contains a clause which states that the Lease has to be drafted and executed, then a Partial Consensus exists.

Full Consensus

In this case, there is full agreement on every point. An accepted Offer-to-Lease is a Partial Consensus. A fully executed Lease is a full consensus.

The Agreement for Lease (i.e., an accepted Offer to Lease) is legally binding even though the Lease hasn't been executed and can be used to commence legal action for financial damages, although it is unlikely that a tenant could sue for specific performance.

The Agreement to Lease is not a Full Consensus as there are still incidental items to be agreed to, but it is strong enough for either party to sue for damages as it contains the essential terms of a lease.

Often the Offer-to-Lease contains subjects or contingency which must be removed before the Offer becomes a contract. Subjects such as approval of the tenant's lawyers or to verify that the intended use complies with the zoning by-laws, or approval of the Board of Directors are examples of clauses found in an Offer-to-Lease.

The accepted Offer-to-Lease or Agreement For Lease can take two forms:

1. An agreement for Lease with an agreed form of lease attached.
In this case, there is a full consensus because the Agreement to Lease contains an agreement to use a Lease which is attached and accepted by both parties.
2. Alternatively, the Agreement to Lease specifies the Lease to be used

The Lease

An executed Lease is a full consensus and requires no further documentation but as mentioned earlier, it is rare that the parties move directly to the lease, preferring to negotiate the Offer-to-Lease first before dealing with the Lease which is a more complex document. Most business people find leases very hard to read and understand. They are written by lawyers for lawyers. Leases tend to be full of clauses covering situations that will probably never develop. This is not suggesting that these clauses are not important because the lease has to provide for a variety of contingencies and possibilities in order to protect the tenant and the landlord against unexpected events.

City Approvals

The leasing process also includes the landlord and tenant obtaining the necessary approvals from the City such as;

- Building Permits related to renovations and leasehold improvements
- Signage Permit
- Occupancy permit
- Business licenses etc.

Types of Leases

Gross Lease

Tenant pays a fixed amount per month. Example \$12,000 per month

The Gross Lease in the first year hopefully includes the landlords operating expenses such as taxes, insurance and maintenance.

Modified Gross Lease

A variation of a Gross Lease

There are numerous forms of "Modified Gross Leases"

Examples:

Tenant pays the increase in the taxes, insurance and maintenance over the base year

Tenant pays the increase in the taxes over the base year and snow removal costs

Indexed Gross Lease or Gross Lease with an escalation clause

A gross lease is increased each year by a percentage that may be specified in the lease or by the change in the specified Consumer Price Index. Used by Government

Triple Net Lease (NNN) or Net Lease

Tenants pay their proportional share of taxes, insurance, and maintenance (TIMs) as spelled out in the lease. Called "Additional rent" Triple Net" or "Net" is an ambiguous term. There are many variations and you need to read the lease.

Under a Triple Net Lease does the tenant pay;

Property management?.

Depreciation of mechanical equipment?

Answer: _____

Expense Stops and Base Year

Landlord pays the "Additional Rent" up to the "Expense Stop" There are a variety of ways to set up expense stops.

Using Base Year The tenant pays the increases in the property taxes over the base year. There are two ways to do this;

1. Property taxes in the first years are absorbed by the landlord. The tenant pays the increase in the property taxes over the base year. If the increase in property taxes over the base year is \$6,000 the tenant pays his pro-rata share of property taxes over \$6,000
2. The base figure is set ahead of time. The tenant pays the property tax increases over \$25,000

Setting the Stop

As an example, the tenant pays for TIM over \$7.00 per Sq. Ft per Yr or pays the operating expenses over \$29,000

Expense Caps

Tenant pays the “Additional Rent” up to the “Cap” Once the Expense Cap is reached, the landlord pays the expenses

As an example, the tenant pays the additional rents up to a maximum of \$8.00 per Sq. Ft per Year. The landlord pays the expenses above \$8.00 per Sq. Ft per yr.

Rent Cap

Puts a ceiling on rent increases.

Examples;

The rent cannot increase by more than the increase in the Consumer Price Index (CPI)

The parking costs cannot exceed \$300 per month over the term of the lease

Types of Rent

Basic Rent

The rent paid E.g. \$20 per Sq. Ft per Year

Additional Rent

Payment for expenses incurred by the landlord as agreed to in the lease. Also called;

Recoverable Expenses

Reimbursable Expenses

Pass Throughs

TIM's (Taxes, Insurance & Maintenance)

CAM's (Common area maintenance)

Free Rent

Generally, free rent only applies to the “Base Rent” not to the “Additional Rent”

Example: Four months of free rent

Generally, free rent will be spread over several years. It's unlikely that the tenant will get the first four months free as this is too risky a proposition for the landlord.

Percentage Rent (Shopping Centers)

% Rents are used by shopping Center landlord for several reasons;

1. When a new shopping center is established the tenants may have trouble surviving until the traffic at the shopping center increases to a satisfactory level. To offset this problem the landlord offers a lower minimum rent and recovers later through the % Rent.
2. The success of a shopping center has a lot to do with tenant mix, promotional campaigns, etc. orchestrated by the mall managers. This in turn makes the retailers more successful and the landlord benefits by receiving a share of the retailer's gross business sales

There are two methods for calculating the % Rent

1. Natural Breakpoint
2. Artificial Breakpoint. The unnatural breakpoint

Natural Breakpoint

Tenant pays the Base Rent or % Rent, whichever is the larger

Example

Base Rent (Minimum Rent): \$500,000 per year

% Rent: 4.00% of sales

Gross Business Sales: \$14,000,000 per year

% Rent: 4.00% x \$14,000,000 = \$560,000

Tenant pays \$560,000

Calculating the Natural Break Point

Natural Breakpoint = $\frac{\text{Minimum Rent}}{\% \text{ Rent}} = \frac{\$500,000}{4.00\%} = \$12,500,000$ per Year of Gross Business Sales

The % Rent kicks in once the gross business sales exceed \$12,500,000

Artificial Breakpoint

(The Unnatural Breakpoint)

The breakpoint is specified.

As an example, the Tenant pays a % Rent of 4.50% of Gross Business Sales once the sales reach \$14,000,000 per year

As an example, the tenant may calculate that they are better off over the long run by paying a higher minimum rent coupled with a higher % Rent break point than paying % Rent based on the natural breakpoint.

Rentable Areas

The area used to calculate the rent.

Industrial. Rentable Area. The area occupied by the tenant

Retail. Gross Leaseable Area (GLA) The area occupied by the tenant

Office Buildings

Rentable Area = Usable Area x Load Factor

Load Factor is also called;

Common Area Factor
R/U Factor (Rentable Area/Usable Area)
Gross Up Factor (More common in Canada)

There are two ways to determine the Load Factor

1. Developed from the plans or by measuring the building
2. Based on local market practice. In this case, the "Load Factor" is not the actual Load Factor for the building but a figure that is used by competitors in the local market place such as 15%

Rentable Area

Used to calculate the rent.

Usable Area

The area occupied by the tenant

Example:
Usable Area: 8,000 Sq. Ft
Load Factor: 15.00%
Base Rent \$12.00 per Sq. Ft per Yr.

Base Rent = 8,000 Sq. Ft x 1.15 x \$12.00 per Sq. Ft per Yr.
= \$110,400 per Yr

Which area? and how will it be measured?

- a) The area being leased has to be identified
 - Usable Area?
 - Rentable Area?
 - Gross Leaseable Area (GLA)?
- b) How will space be measured?

The industry-wide space measuring standards are the **BOMA Standards** which include:

Gross Areas of a Building: Standard Methods of Measurement
 Office Buildings: Standard Methods of Measurement
 Retail Buildings: Standard Methods of Measurement
 Industrial Buildings: Standard Methods of Measurement
 Multi-Unit Residential Buildings: Standard Methods of Measurement

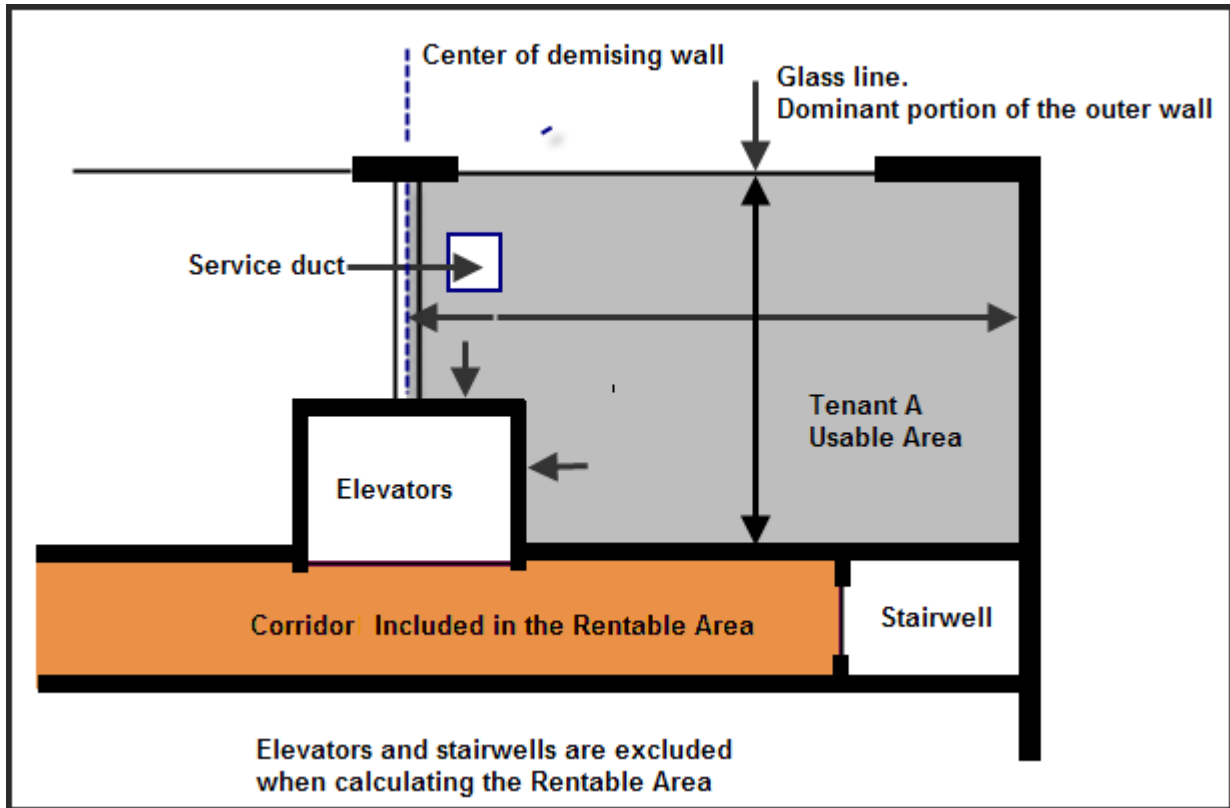
Note: The landlord and tenant can decide how they wish to measure the space

Measuring Office Buildings using the BOMA Standards

Following are some of the general rules specified by the BOMA Standard

Outer wall. Measure to the inside of the dominant portion (over 50%) of the outer wall
 Demising or partition walls. Measure to the center of the partitions that separate tenants
 Corridor walls. Measure to the inside of the wall from the tenant's side

Exclude stairwells, elevator shafts, vents or ducts that serve multiple tenants



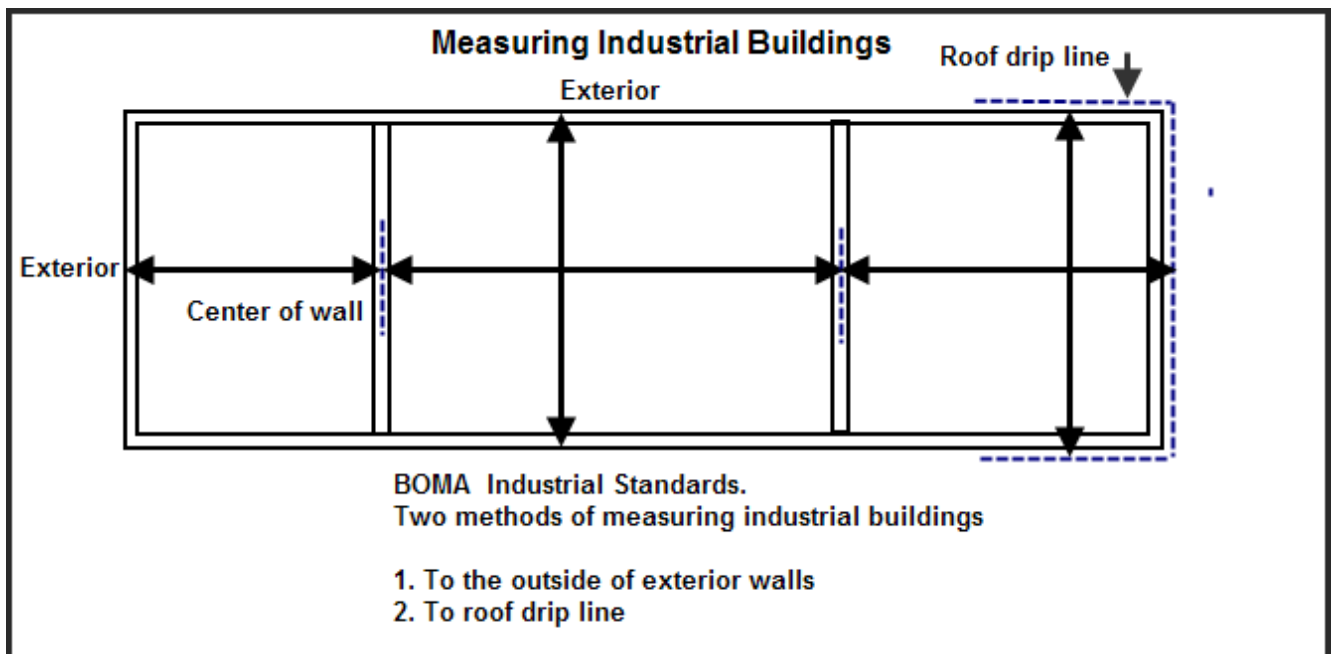
Measuring Retail and industrial buildings

Generally measured from the outside face of exterior walls to the center of demising walls. There is no increase for common areas.

Sometimes the exterior measurement is to the drip line at the perimeter of the roof system. This is covered in the BOMA Industrial Standards. This 'Drip Method' method favors the landlord as it increases the rentable area.

The lease should specify which method will be used.

Certain features of an industrial building are excluded from the calculation of area, including canopies, unenclosed connecting links, unenclosed exterior staircases or fire escapes and unenclosed shipping/receiving platforms. The main condition for an area to be excluded is that it exists beyond the measuring line.



Flex Space Buildings

Flex space combines elements of both office and industrial space into a building that could be used for either activity. Although flex space can accommodate light manufacturing and warehousing of goods, the buildings are often configured as multi-tenant, multi-story buildings that have features similar to office buildings, like building lobbies, toilets, mechanical rooms, trash staging and other building common service areas.

The BOMA Standard for Measuring Industrial Space describes how to measure flex buildings.

Who will do the measuring?

1. Landlord and tenant jointly. What if they can't agree?
2. Surveyor?
3. Who pays?

Leasing new space

If the building is under construction or requires major leasehold improvements, the following are unknown;

1. The final area (Rentable, Usable or Gross Leaseable Area)
2. Final Construction costs
3. Completion time. Issuance of occupancy permits and business licenses
4. When will the tenant be able to move in?
5. What happens if the space is not ready on the specified date?
6. Which area and how do we measure?

Handling the unknowns

Not knowing the exact area can create many problems for the tenant.

Example;

The Area is supposed to be 5,000 sq. ft and the base rent \$20 Psf per Yr.

However, a wall had to be moved and the final area is 6,000 sq. ft. This means the extra rent is 1,000 Sq. Ft x \$20 Psf per Yr. = \$20,000

Should the tenant pay the extra \$20,000 per year?

It's a matter of "Tolerance"

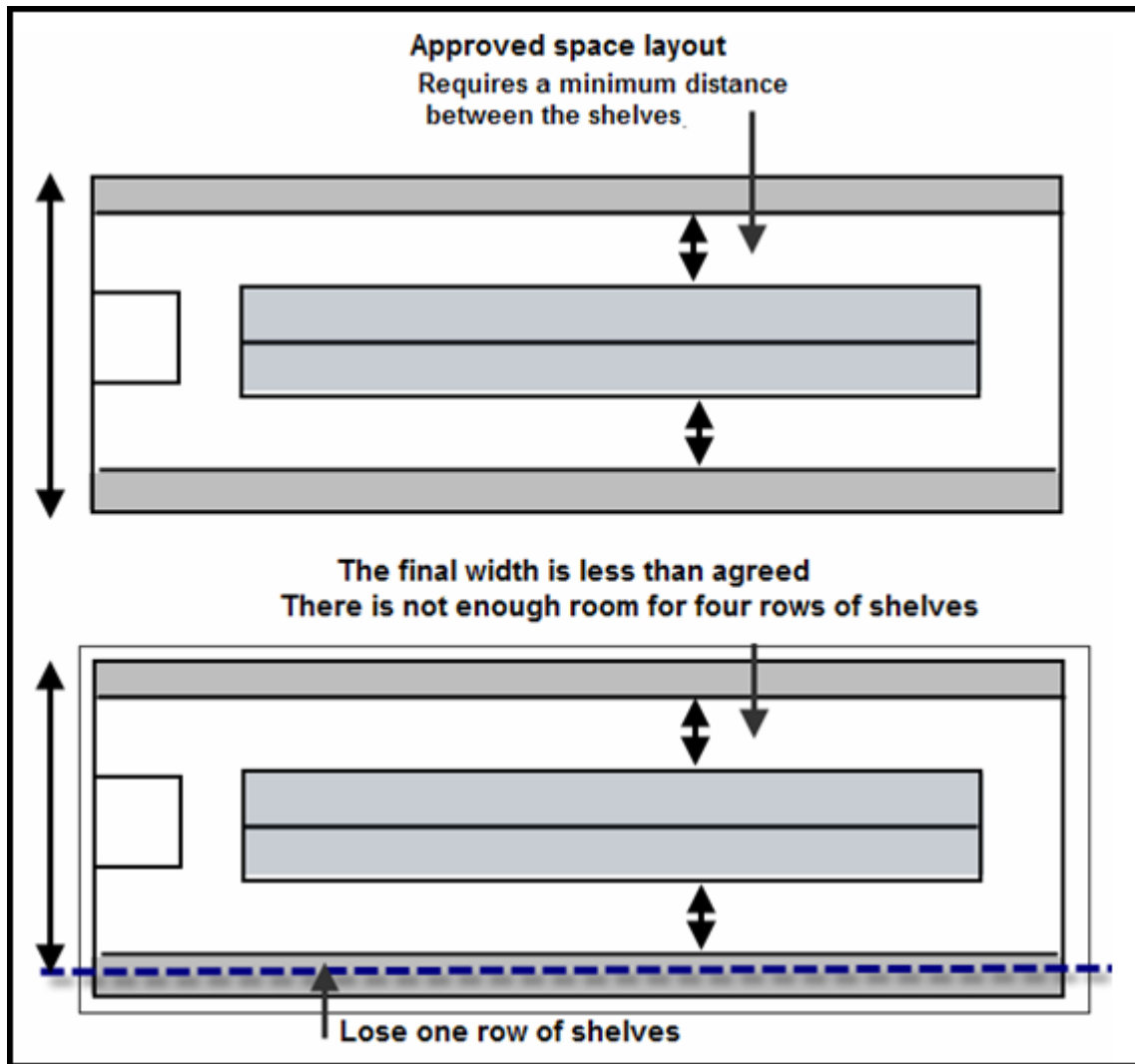
- The area is the Usable area measured according to the BOMA standards
- The usable area as defined by BOMA will be 5,000 sq. ft \pm 10%
- Dimensions: Depth 60 feet \pm 5%
Width 80 feet \pm 5%
- The lease should specify what happens if the tolerances are violated

In certain cases, the dimensions, particularly the width, can be very important to the tenant as illustrated below.

Case Study

For some tenants, particularly retail tenants, require a minimum store width in which to operate.

Example: Bookshop



Tenant Improvements (TI's) & Build outs

Shell Lease

(common in new shopping centers)
Landlord provides the absolute minimum. Floor, roof & outer wall
Utilities, HVAC are brought to the premises by the landlord but not into the tenant's space.

The tenant is responsible for finishing. The landlord may exercise very tight control over the quality of the finishes. The tenant has to complete the leasehold improvements according to the landlord's detailed specifications.

Turnkey Lease

Opposite of Shell lease. Landlord pays for the tenant leasehold improvements based on the extensive specifications

The landlord may do this to help a tenant start their business. E.g. Young Dentist.

Shell Lease with allowance - Landlord builds

Landlord performs the tenant improvements based on the agreed-upon specifications.

Tenant is responsible for costs above the specified allowance.

Big problem.

The tenant is told that the landlord will provide a TI allowance of \$30 per Sq. Ft. The rentable area is 25,000 Sq. Ft and the Usable Area is 22,500 Sq. Ft

The tenant calculates the TI's based on the Rentable area $\$30 \times 25,000 = \$750,000$
The landlord uses the Usable Area $\$30 \times 22,500 = \$675,000$

A difference of \$75,000

TIP: Ask the landlord to provide the TI Allowance in total dollars instead of \$ per Sq. Ft

Shell Lease with Allowance – Tenant builds

Tenant builds and landlord reimburses based on the agreed-upon improvement allowance

The landlord will be concerned about the quality of the work and may require detailed specifications. He will be concerned that the other tenants are not disturbed.

Build to Suit. Single tenancy building

Common in quality industrial parks.

Removes the risk of developing speculative industrial space for lease

The major concern is the creditworthiness of the tenant and the length of the lease

Construction Cost Overruns

How will they be handled?

Example

Estimate	\$500,000	
Lowest Bid	\$560,000	(\$60,000 over)
Actual Cost	\$590,000	(\$90,000 over)

The lease has to deal with cost overruns and remedies

If the TI's are an "allowance" the tenant pays for the cost overrun by;

1. Reimbursing the landlord for the cost overrun
2. Adding the cost overrun to the rent

Example. Adding the cost overrun to the rent over the first term

Rentable Area: 7,000 Sq. Ft
 Amount above the allowance: \$90,000
 First term: 5 years

\$90,000, Interest Rate 9%, Amortization 5 years
 Monthly Payment: \$1,868
 Increase in rent. $\frac{\$1,868 \times 12}{7,000} = \3.20 psf per yr.

Recovering Tenant Improvement (TI's)

There are two ways a landlord can recover the expenditures on leasehold improvements from the tenant.

- a) Increase the rent. Generally over the first term of the lease if there is an option to renew
- b) Provide a loan to the tenant (less common)

Example.

Calculating the increase in the rent to recover the cost of the tenant improvements provided by the landlord

The landlord and tenant have agreed that the landlord will provide and pay for the leasehold improvements of \$35,000 at an interest rate of 9.00% per year compounding monthly.

Rentable Area: 4,500 Sq. Ft
 TI's: \$35,000
 Interest: 9.00%
 Amortization: 5 Years (First term)

Monthly payment: \$727 for 5 years

Increase the base rent for the TI's = $\frac{\$727 \text{ per Mo} \times 12}{4,500 \text{ Sq. Ft}} = \1.94 per Sq. Ft per Yr

Completion Date & Occupancy

Major issues arise if the move-in deadline is missed. It can be disastrous for the tenant and costly for the landlord. There is a lot to be accomplished before the tenant can move in and a lot can go wrong.

- Preparation and approval of the drawings and submission to the city
- City approvals
- Development of working drawings
- Obtaining and selecting contractor or subcontractors
- Construction
- Final inspection
- Obtaining city approval for occupancy, business license, signage, etc.

TIP: You need to learn the city approval process

The Tenant “Nightmare”

1. Vacating their current space Aug 31
2. Move-in date is September 1
3. Their current space has been rented starting Sept 1
4. The September 1 date is important because they want to be ready for the Xmas sales period

Due to delays, the space won't be ready until Dec 1 which means they completely miss the Xmas sales period. A well-written lease will deal with these critical issues and the remedies based on the needs and concerns of both parties.

Lease Starting Date Issues

The tricky part is when “does the term start?” if construction or major tenant improvements are involved.

If the landlord fails to provide occupancy the tenant may face significant business challenges and costs.

Examples:

The tenant has to vacate their existing premises because it has been leased and may be forced to occupy temporary space. A costly and disrupting event for the tenant.

Tenant needs to be in the Mall by October to prepare for the Xmas sales period.

Accounting firm needs to move in by year-end to be prepared for the upcoming busy tax preparation period.

There are a lot of things to be done by the tenant and the landlord to prepare for the move including obtaining the necessary city permits, signage approvals, etc.

There may be serious consequences for the tenant if the space is not ready on the commencement date. The lease needs to deal with the rights and remedies for the tenant under these circumstances.

The space may be ready but other conditions prevent the tenant from moving in such as;

- Parking is not ready for staff and customers
- Elevators or air conditioning is not working.
- Space is ready but the City hasn't issued the occupancy permit.

Force Majeure

Delays caused by events beyond the control of the landlord such as strikes, bad weather, etc. that delays construction

If the Tenant is responsible for the tenant improvements

In this case, the risk of delivery has been transferred from the landlord to the tenant.

End of Term

Easy to determine once the beginning date for the term has been established.

Completion Date & Occupancy

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- City approvals
- Development of working drawing
- Obtaining and selecting contractor or subcontractors
- Construction
- Financial inspection
- Obtaining city approval for occupancy, sign approvals, etc.

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Remedies for late delivery by the landlord

The lease needs to establish how late delivery of the space will be handled. This will depend on the needs of the tenant, the costs involved and business implications.

Example:

If the tenant can't move in by Sept 30 they can elect to postpone the move and commencement of the term until March of the following year.

Damages.

How will the tenant be compensated for the delay?

The landlord may be required to pay for the move to and from the temporary premises.

Lease Term, Option to Renew and Bumps or Steps

The term is the contractual time period that the tenant has the right to occupy the space.

The simplest form is a month to month tenancy called a **“Periodic Tenancy”**. Either party can give one month's notice.

The lease contract ends at the end of the lease term and may offer an **“Option to Renew”**. The lease may provide for periodic rent increases during the lease term called **“Bumps”** or **“Steps”**.

The option to renew the lease for another term is to the tenant advantage and might or might not be attractive to the landlord.

Establishing the **“Bump or “Step” or “Renewal Rate”**

There are a variety of ways to establish the new rent rate;

1. The amount is specified. Example: \$25.00 Psf per Yr
2. Based on the change in the Consumer Price Increase (CPI) over the previous term.
3. Change in the CPI but subject to a cap of 7.00%
4. Fair Market Value (FMV)

There are many ways to find Fair Market Value (FMV) Rents and there are a lot of issues that make finding the FMV Rent difficult.

The lease will specify who is responsible for establishing the FMV Rent. Some examples are;

- Landlord & tenant attempt to come to an agreement on their own within a specified time period.
- If they can't agree they appoint an appraiser. One party provides a list of qualified appraisers and the other party selects the appraiser.

Rents can change during the term

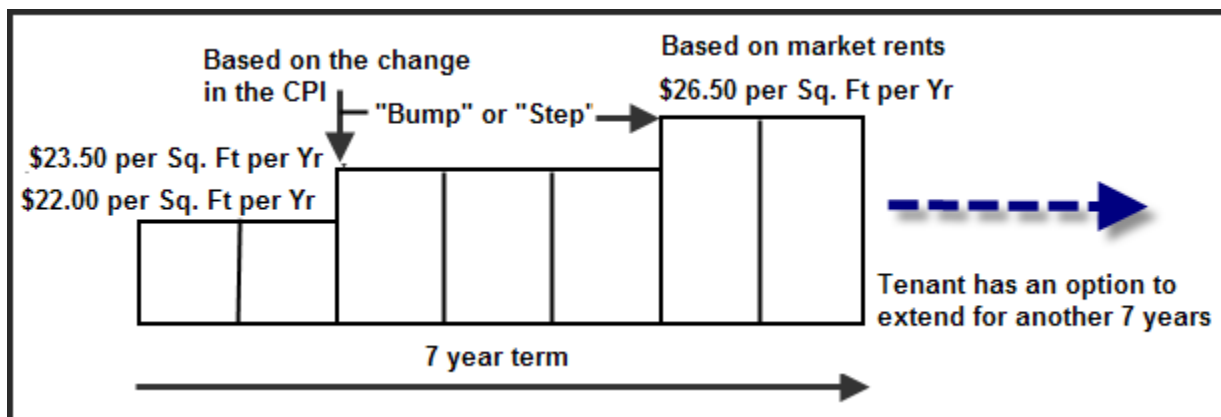
Rents can be adjusted during the term. As an example;

First Term: 7 years with an option to renew for another 7 years

Base Rent: 1. First two years. \$22.00 Psf per Yr.

2. Then increased by the change in the CPI

3. End of first five years. Rent to be adjusted based on FMV rents



Establishing comparable lease rates

Establishing a lease rate from comparables can be very difficult. Why?

1. Landlords tend to be secretive about the lease rates making it difficult to obtain the rent rates from comparable properties
2. There can be many underlying factors that influence lease rates. In the following example, the **tenant uses comparable A** and the **landlord use comparable B**

The tenant claims the market rent is \$21.00 per Sq. Ft per Yr. and the landlord claims \$24.00 per Sq. Ft per Yr

	Tenant Comparable A	Landlord Comparable B
Rentable Area	15,000 Sq. Ft	20,000 Sq. Ft
Current Rent Rate	\$21.00 per Sq. Ft per Yr	\$24.00 per Sq. Ft per Yr
Term	5 years	5 years
Underlying factors influencing the lease rate		
Free rent	One month	One month per year for 3 years
Tenant Improvements Landlord	\$0	\$150,000
Tenant	\$70,000	\$0
Recoverable expenses	\$8.00 per Sq. Ft per Yr Increasing at 3% per Yr	\$10 per Sq. Ft per Yr Increasing at 3% per Yr
Net Effective Rent at 10%	\$19.02	\$15.07

Assignment

A transfer of all the tenant rights to the space to the subtenant.

Sublease

A transfer of some of the tenant rights to the subtenant.

Example: Renting a portion of the space to the subtenant

Provides an exit strategy for the tenant if more space is needed or wants to close down the business

The landlord is concerned about the loss of control over the tenancy, type of tenant, etc. A major concern is a tenant profiting from the sublease.

Tenant Profiting of Subletting. Example.

A tenant has rented 10,000 Sq. Ft at \$20 per Sq. Ft per Yr for a five year term with an option to renew for another five years.

After three years the tenant decides to sublet 4,000 Sq. Ft. At this point, the lease rate has shifted from \$20 to \$28 per Sq. Ft per Yr.

This means the tenant will pocket;

$$4,000 \text{ Sq Ft } (28-20) \times 2 \text{ years} = \$64,000$$

This upsets the landlord.

Possible Solutions. The lease states;

That all subleasing profits accrue to the landlord. Not a good solution as there is no incentive for the tenant to sublease at a higher rate

The landlord and tenant agree to share the profits with 60% to the landlord and 40% to the tenant after deducting real estate leasing commission and legal fee paid by the tenant and the landlord.

Operating Expenses & Recoverable Expenses

There are many issues related to the allocation of the operating expenses to the tenant as defined in the lease

Definition of Operating Expenses

A well designed lease will be very explicit as to the definition of the operating expenses that are paid by the tenant and by the landlord.

The lease may state that the landlord is responsible for Structural Repairs". The term "Structural Repairs" is not what you think.

Structural" is not necessarily the physical structure such as columns, load bearing walls, columns, the roof, etc.

There is a variety of ways to define "structural"

1. It depends on the dollar amount involved. Not a good solution
2. Improvement or repairs to intrinsically important elements of the building
 - Load bearing walls & columns
 - Electrical, plumbing, sprinkler systems
 This approach is favored by the tenant
3. Repair to structural components such as columns, trusses, roof, etc. which is the method favored by the landlord

Pro-rata Share of Operating Expenses

Allocating operating expenses between tenants is fraught with difficulties. Following are some of the issues about the distribution of operating expenses that can develop between the landlord and the tenant

Recovery by the Landlord of Operating Expenses related to "Vacant Space"

The Landlord may try and transfer the operating expenses for vacant space by having the tenants pay for their share of the operating costs for the vacant space. There are three main approaches used.

1. The landlord pays the operating expenses for the vacant space
2. The tenants pay their share of the expenses of the operating expense for the vacant space
3. The vacancy is set permanently at a specified percentage.
 - E.g. 5% or 95% occupancy regardless of the actual vacancy or 95% or building is 100% rented

Example. Tenant A. Operating Expenses \$480,000 per year

Total Leasable Area: 60,000 Sq. Ft

Tenant A. Occupies 20,000 Sq. Ft of the space (33%)

Total area leased: 50,000 Sq. Ft

Vacant space: 10,000 Sq. Ft (17%) Assumed vacant for one year

Calculation of Tenant's A's share of the operating expenses of \$480,000 per year**1. Landlord pays the operating expenses on the vacant space**

Tenant A share of operating costs is:

$$\frac{\text{Operating Expenses} \times \text{Area Leased}}{\text{Total Leasable Area}} = \frac{\$480,000 \times 20,000 \text{ Sq. Ft}}{60,000 \text{ Sq. Ft}} = \$160,000$$

2. Tenant A pays their proportional share of the operating cost on the vacant space

Tenant's share of operating costs is:

$$\frac{\text{Operating Expenses} \times \text{Area Leased by Tenant}}{\text{Total Area Leased (Not the Total Leasable Area)}} = \frac{\$480,000 \times 20,000 \text{ Sq. Ft}}{50,000 \text{ Sq. Ft}} = \$192,000$$

3. Using a Permanent Vacancy Rate set at 5% or 95% Occupancy

Tenant's share of operating costs is:

$$\frac{\text{Operating Expenses} \times \text{Area Leased by Tenant}}{\text{Total Leasable Area} \times 95\%} = \frac{\$480,000 \times 20,000 \text{ Sq. Ft}}{60,000 \text{ Sq. Ft} \times 95\%} = \$168,421$$

Summary. Calculation of Tenant's A share of the \$480,000 annual operating expenses

Note: Assumes the space is vacant for one year

Method	Tenant A Share of operating costs
1. Landlord pays the Op Cost on the vacant space	\$160,000
2. Tenant A pays share of op expenses on vacant space	\$192,000
3. Vacancy rate is set permanently at 5%	\$168,421

Grossing-Up Operating Expenses

A property's occupancy rate rises or falls, certain operating costs also rise and fall. Costs that typically fluctuate with occupancy include janitorial, garbage removal and utility costs.

Most commercial leases which allocate operating costs on a proportionate share basis include a provision that allows the landlord to increase or "gross-up" operating costs to reflect what the expenses would amount to if the property was fully occupied (or nearly so).

That is, the landlord is empowered to overstate the expenses as if the property was fully tenanted. As a result, the amount the tenant must pay based on its proportionate share, increases.

Example. Pro-rata Share of Property Taxes

A well located retail store has two tenants.

Tenant 1. 20,000 Sq. Ft Discount Store

Tenant 2. 10,000 Sq. Ft upscale restaurant with \$1,500,000 of leasehold improvements

The property taxes are \$40,000

On a pro-rata basis the distribution of the property taxes are;

$$\text{Discount Store} \quad \frac{20,000 \times \$40,000}{30,000} = \$26,667$$

$$\text{Upscale Restaurant} \quad \frac{10,000 \times \$40,000}{30,000} = \$13,333$$

The Discount Store “argues that the property taxes are inflated by the Upscale Restaurant expensive leasehold improvements and want their share of the property taxes reduced.

Note: Combining a Discount Store with an Upscale Restaurant is an example of poor “Tenant Mix”

Tenant creates additional operating expenses

There are many instances where an operating expense is created by an individual tenant that should not be charged to other tenants.

Examples

One tenant in an office building operates 24 a day, 7 days a week which increases the air conditioning costs

A strip center has a video game outlet and security is required because of kids loitering in the area and causing problems in the center. Is it fair for the other tenants to pay their pro-rata share of the security costs created by one tenant?

Landlords often reserve the right to allocate operating costs different to the tenant’s pro-rata share.

Renovating and Subdividing Space. Issues

Load bearing and shear walls systems

Building loads consist of

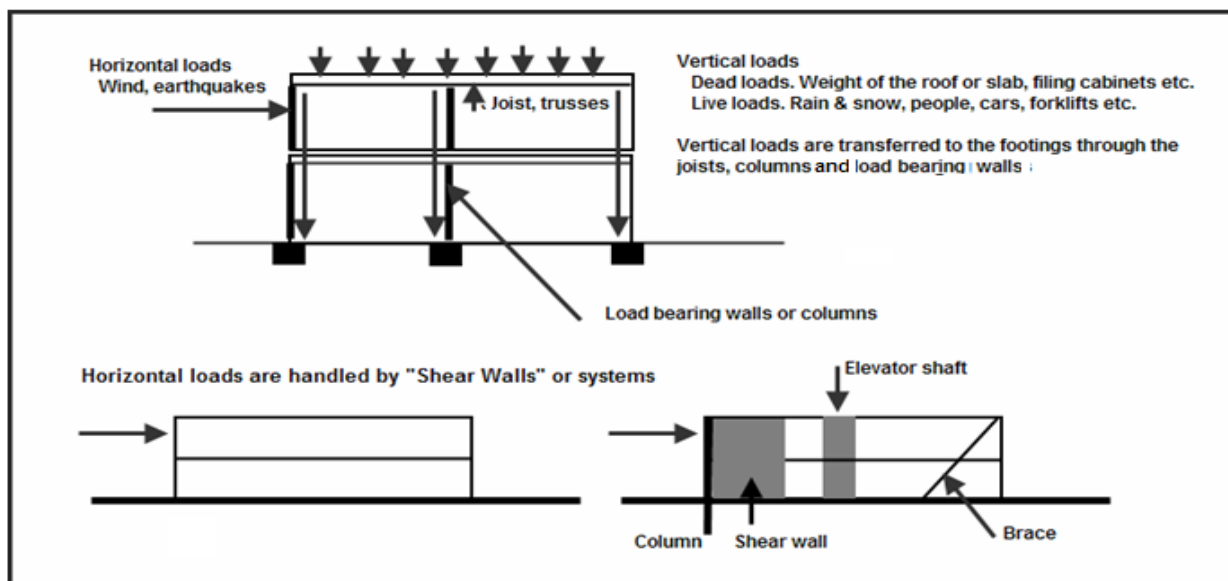
Vertical Loads which are broken down into:

1. **Dead Loads** such as weight of the roof and floor slabs and static equipment such as filing cabinets, storage racks, furniture, etc. These loads are transmitted to the foundations via floor slabs, trusses and load bearing walls and columns
2. **Live Loads** such as rain and snow on falling on the roof, moving equipment such as forklifts, cars and people

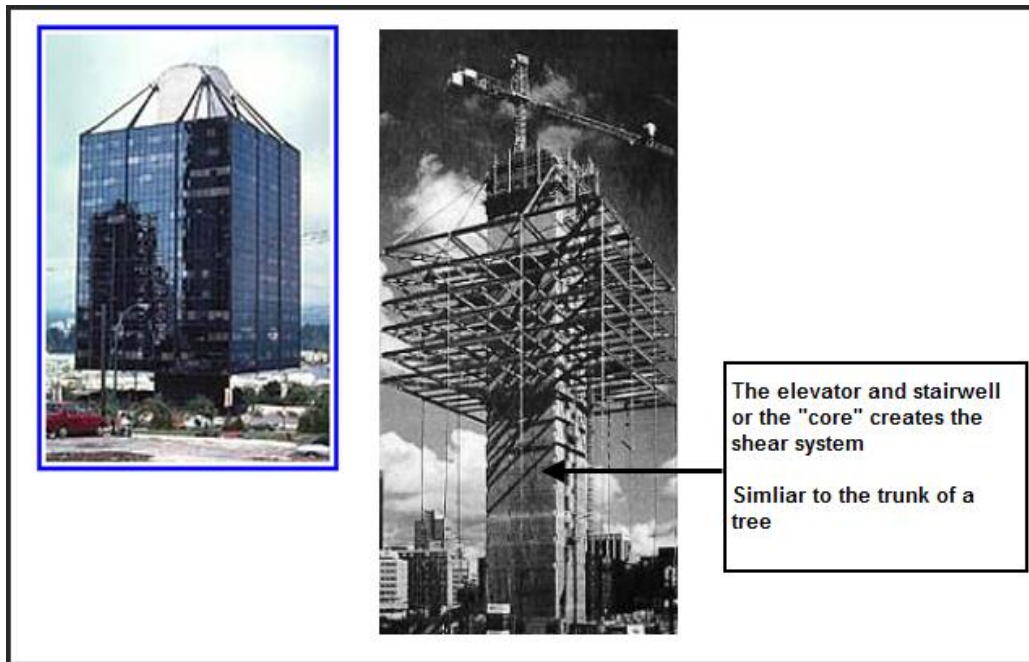
Vertical loads are transmitted to the foundations via floor slabs, trusses, load bearing walls and columns

Horizontal Loads that want to push the building such as wind, earthquakes, etc.

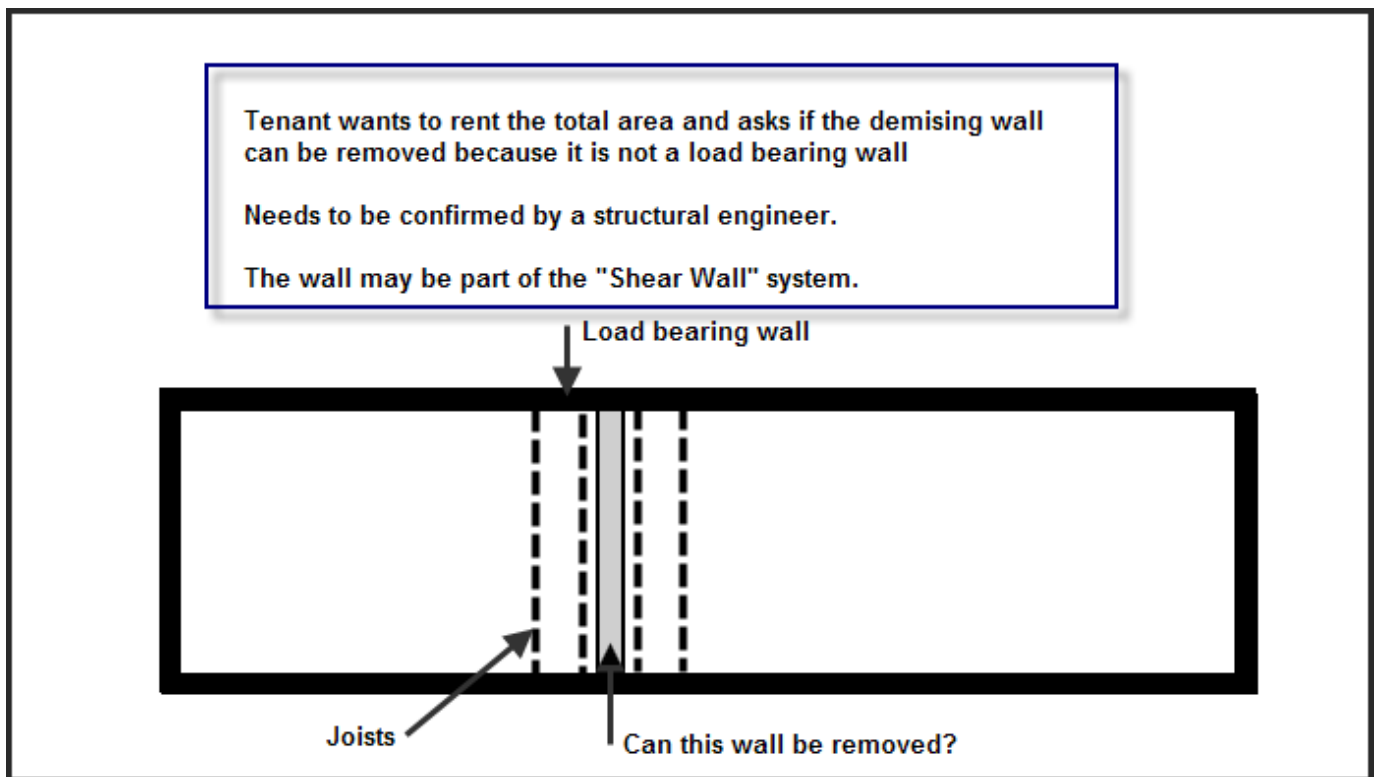
Structural engineers design a shear system to prevent horizontal movement of the building. Shear systems may consist of shear walls, columns that are designed to resist horizontal forces. In many buildings the elevator shaft and stairwells are an important part of the shear system.



The elevator shaft and stairwells are often a major part of the shear system as illustrated in this photo.



TIP: Never make statements about removing walls in commercial buildings even if they appear to be non-load bearing as they may be part of the shear structure.



Subdividing Space: Case Study

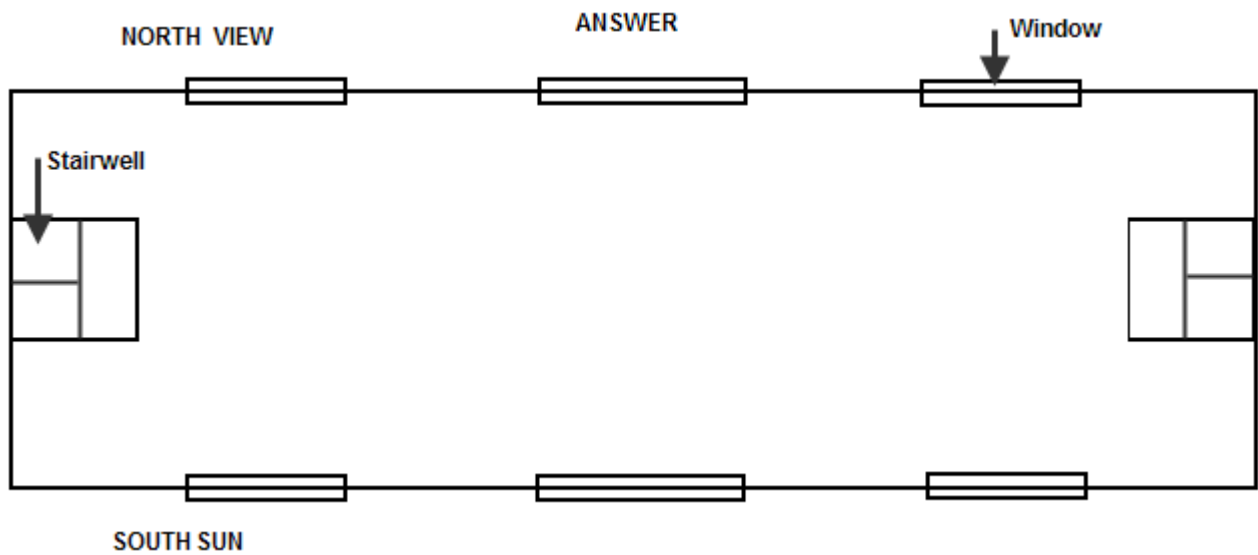
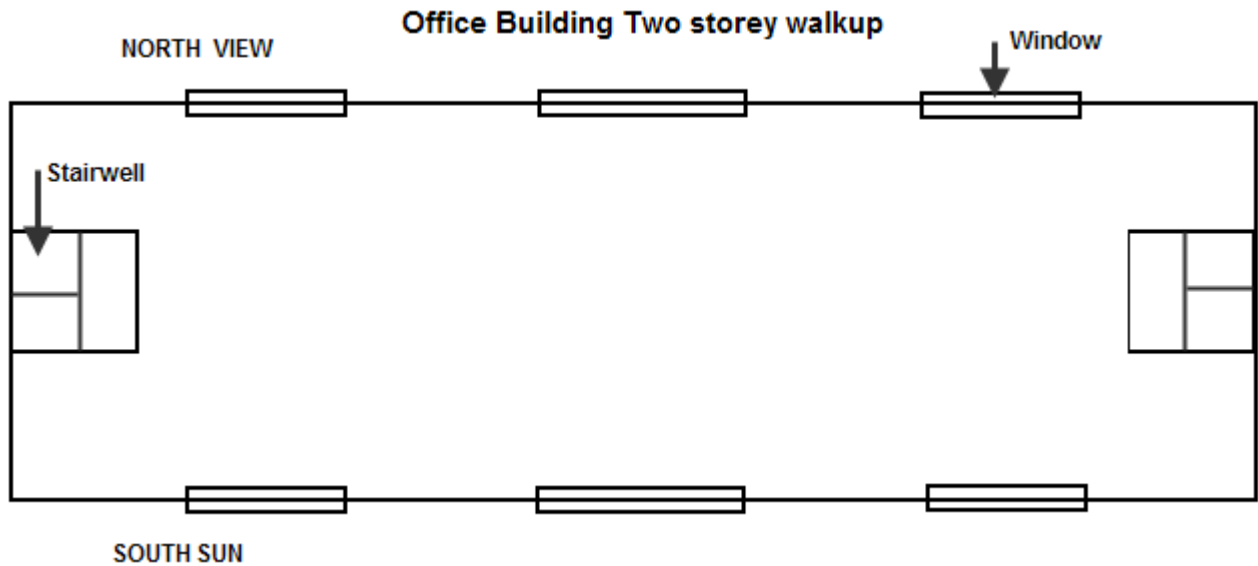
You are leasing the second floor of a two storey office building and have found two tenants interested in renting.

Tenant A wants approximately 1/3 of the space

Tenant B wants approximately 2/3 of the space

Both tenants want to **face north** to view the majestic mountains and **face south** for the morning sun.

Exercise. Subdivide the space



TIP _____

Lease Comparison Analysis

When comparing leases you calculate the total costs each year and then use a Discount Rate to calculate the Net Present Value (NPV) and the Net Effective Rent

Note: You cannot calculate the Internal Rate of Return (IRR) because there is no investment.

Example:

A tenant is considering two different spaces and has established the following annual costs taking in to account the base rent, additional rent, free rent and parking costs.

Which is the best proposal from a financial perspective?

Using a 10.00% Discount Rate

Net Effective Rent = $\frac{\text{Net Present Value}}{\text{No. of Years} \times \text{Area}}$

Year	Space A	Space B
	4,000 Sq Ft	4,000 Sq Ft
1	\$120,000	\$115,000
2	130,000	122,000
3	142,000	131,000
4	145,000	135,000
5	148,000	140,000
6	150,000	172,000
7	152,000	176,000
8	154,000	178,000
9	157,000	182,000
10	163,000	185,000
NPV at 10%	\$878,089	\$901,884
Net Effective Rent at 10%	$\frac{\$878,089}{10 \text{ yrs} \times 4,000 \text{ Sq. Ft}}$ \$21.95 per Sq. Ft per Yr \$1.83 per Sq. Ft per Mo	$\frac{\$901,884}{10 \text{ yrs} \times 4,000 \text{ Sq. Ft}}$ \$22.55 per Sq. Ft per Yr \$1.88 per Sq. Ft per Mo

From a Tenant's perspective, Space A has the lowest Net Effective Rent and is the best deal from a financial perspective.

Case Study: Space comparison example

Illustrates the importance of calculating the total annual costs when comparing space to rent in different buildings.

You are working with a tenant who requires 750 Sq. Ft of usable space and you have found the following buildings;

1. Plaza 500 which is a prestigious suburban office tower which rents for \$16 psf per Yr
2. Westview which is a quality three storey office building for \$14 per Sq. Ft per Yr



The tenant is keen on the more prestigious Plaza 500 since the rent is only \$2.00 per Sq. Ft per year or \$1,500 per more. You explain to the tenant that we have to work out the total annual cost before we can make an intelligent decision. The leasing information is as follows;

	Plaza 500	Westview
Area	750 Sq. Ft	750 Sq. Ft
Base Rent	\$16 psf. per Yr	\$14 psf. per Yr
Gross Up Factor	17%	12%
Free Rent. <i>Only applies to the Base Rent. Tenant pays Additional Rent</i>	One month	Two months
Additional Rent	\$7.20 per Sq. Ft per Yr	\$5.32 per Sq. Ft per Yr
Parking Three cars	\$40 per month per space	Free
Term	Three years	Three years

Calculation of yearly cost.**Plaza 500**

Rentable Area = Usable Area x Gross Up = 750 x 1.17 = 877.50 Sq. Ft

Base Rent \$16 per Sq. Ft per Yr x 877.50 Sq. Ft (Rentable)	\$14,040
Additional Rent (TIM's) \$7.20 x 877.50 Sq. Ft Rentable	6,318
Free Rent Adjustment. One month Base Rent \$14,040/12	(1,170)
Parking. Three cars \$40 x 3 x 12	<u>1,440</u>
	\$20,628 per Yr.
	\$ 27.50 per Sq. Ft of Usable Area per Yr.

Westview

Rentable Area = Usable Area x Gross Up = 750 x 1.12 = 840 Sq. Ft

Base Rent \$14 per Sq. Ft per Yr x 840 Sq. Ft (Rentable)	\$11,760
Additional Rent (TIM's) \$5.32 x 840 Sq. Ft Rentable	4,468
Free Rent Adjustment. Two month Base Rent (\$14,040/12) x 2	(1,960)
Parking. Three cars Free	<u>0</u>
	\$14,268 per Yr.
	\$ 19.02 per Sq. Ft of Usable Area per Yr.

Difference \$6,360 per Yr.

KEY POINTS

The tenant focuses on the cost of the area occupied which is the "Usable Area"

Comparing rents using the "\$ per Sq. Ft per Yr" only the Base Rent can be very misleading as illustrated above.

When comparing spaces always calculate the total cost per year

The above analysis ignores how the cash flow change over the term of the lease.

The next lease analysis example analyzes and compares the leases over time instead of comparing for one year.

Lease Comparison Example

You are representing a landlord with 6,000 Sq. Ft of industrial space to rent has received proposals from two tenants. The landlord has asked you to tell him which is the best deal from a financial perspective based on a before tax analysis.

Rentable Area: 6,000 Sq. Ft

Discount Rate for calculating the Net Effective Rent: 10%


Leasing Commission: \$12,000

Estimated termination costs: \$7,500

Lease Term: 10 years

	Tenant 1 Proposal	Tenant 2 Proposal
Leasehold Improvements By landlord	\$20,000	\$60,000
Base Rent and escalations	\$14 per Sq. Ft per Yr. for five years then increased by the increase in the CPI estimated to be 3.00% per year	\$16.50 per Sq. Ft per Yr for three years then \$18 for three years then \$20
Free Rent	First month excluding Recoverable Expenses	First month of each year for three years
Landlord's operating expenses	\$5.00 per Sq. Ft per Yr. increasing at 3.00% per year compounding	Same
Additional Rent or Recoverable expenses)	\$4.00 per Sq. Ft per Yr. increasing at 3.00% per year compounding	Same
Parking	\$20 per Space per month x 20 cars subject to a Rent Cap of \$300 per space per Yr.	Free parking
Termination costs	\$7,500	Same
Net Effective Rent at 10%	\$8.10 per Sq. Ft per Yr.	\$8.81 per Sq. Ft per Yr

Net Effective Rent Report. Tenant 1 Proposal

		Landlord. Net Cash Flow & Net Effective Rent (Before Tax) Lakewood Industrial Park Tenant 1 Proposal					Investor Pro Webinar IQ Lease Landlord Proposal 1	
LANDLORD								
Year	Leasehold Improvements Costs	Financing of Improvements		Tenant Loans		Operating Cash Flow (Before Tax)	Termination Costs (Before Tax)	Net Cash Flow (Before Tax)
		Borrow	Paid Back	Loan	Paid Back			
Year 1 Jan-Year 1 Dec	\$ (20,000)	-	-	\$ (8,000)	-	\$ 63,920	-	\$ 35,920
Year 2 Jan-Year 2 Dec	-	-	-	-	-	82,855	-	82,855
Year 3 Jan-Year 3 Dec	-	-	-	-	-	82,794	-	82,794
Year 4 Jan-Year 4 Dec	-	-	-	-	-	82,740	-	82,740
Year 5 Jan-Year 5 Dec	-	-	-	-	-	82,629	-	82,629
Year 6 Jan-Year 6 Dec	-	-	-	-	-	93,924	-	93,924
Year 7 Jan-Year 7 Dec	-	-	-	-	-	93,840	-	93,840
Year 8 Jan-Year 8 Dec	-	-	-	-	-	93,600	-	93,600
Year 9 Jan-Year 9 Dec	-	-	-	-	-	93,420	-	93,420
Year 10 Jan-Year 10 Dec	-	-	-	-	-	93,180	(7,500)	85,680
						Total Net Cash Flow (Before Tax)		827,402
						Net Present Value (NPV) at 10.00%		486,097
Before Tax Summary								
Total Rentable Area	6,000 Sq. Ft							
Total Net Cash Flow	\$ 827,402							
Average Annual Net Cash Flow	\$ 82,740 per Year							
Average Monthly Net Cash Flow	\$ 6,895 per Month							
		Rentable Area						
Total Rate	\$ 137.90 Sq. Ft							
Average Effective Annual Rate	\$ 13.79 Sq. Ft per Yr							
Average Effective Monthly Rate	\$ 1.15 Sq. Ft per Mo							
Net Present Value at 10.00%	\$ 486,097							
Net Effective Rent at 10.00%	\$ 8.10 Sq. Ft per Yr							
	\$ 0.68 Sq. Ft per Mo							

Tenant 1 and Tenant 2 Lease Comparison Report

Lease Comparison Report			
		Landlord Analysis Webinar IQ Lease Landlord Proposal 1	Landlord Analysis Webinar IQ Lease Landlord Proposal 2
		<u>Net Cash Flow (Before Tax)</u>	<u>Net Cash Flow (Before Tax)</u>
Year	0	(28,000)	(68,000)
	1	63,920	77,540
	2	82,855	89,360
	3	82,794	89,180
	4	82,740	97,500
	5	82,629	97,259
	6	93,924	111,300
	7	93,840	111,120
	8	93,600	110,880
	9	93,420	110,700
	10	85,680	102,960
	Total	<u>827,402</u>	<u>929,798</u>
Before Tax Financial Summary			
Total Rentable Area		6,000 Sq. Ft	6,000 Sq. Ft
Total Net Cash Flow		\$ 827,402	\$ 929,798
Average Annual Net Cash Flow		\$ 82,740	\$ 92,980
Average Monthly Net Cash Flow		\$ 6,895	\$ 7,748
Average Rent Rates			
Based on Rentable Area			
Average Effective Annual Rate		\$ 13.79	\$ 15.50
Average Effective Monthly Rate		\$ 1.15	\$ 1.29
Net Present Value and Net Effective Rent			
Net Present Value (NPV)		\$ 486,097	\$ 528,545
NPV Discount Rate (Before Tax)		10.00%	10.00%
Based on Rentable Area			
Net Effective Yearly Rent		\$ 8.10	\$ 8.81
Net Effective Monthly Rent		\$ 0.68	\$ 0.73

Example: Tenant Lease Analysis. Office Space Net Cash Flow and Net Effective Rent

Project Info.	Tenant	Leasehold Improvements	Leasing Expenses	Sublease Revenue	Vacancy	Financing	Termination
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Tenant. Net Cash Flow & Net Effective Rent (Before Tax)						
				Capital Plaza 306 CTA Realt	August 11, 2011 Investor Pro	
				Lease Analysis Tenant Office Single Space		
TENANT						
Year	Tenant Leasehold Improvements	Financing of Improvements		Operating Cash Flow (Before Tax)	Termination Costs (Before Tax)	Overall Rental Costs (Before Tax)
		Borrow	Paid Back			
Year 1 Jan-Year 1 Dec	\$ 15,000	\$ (15,000)	-	\$ 98,098	-	\$ 98,098
Year 2 Jan-Year 2 Dec	-	-	-	124,564	-	124,564
Year 3 Jan-Year 3 Dec	-	-	-	210,964	-	210,964
Year 4 Jan-Year 4 Dec	-	-	-	210,964	-	210,964
Year 5 Jan-Year 5 Dec	-	-	-	210,964	-	210,964
Year 6 Jan-Year 6 Dec	-	-	-	231,826	-	231,826
Year 7 Jan-Year 7 Dec	-	-	-	231,826	-	231,826
Year 8 Jan-Year 8 Dec	-	-	-	231,826	-	231,826
Year 9 Jan-Year 9 Dec	-	-	-	231,826	-	231,826
Year 10 Jan-Year 10 Dec	-	-	-	231,826	10,000	241,826
				Total Rental Costs (Before Tax)	2,024,684	
				Net Present Value (NPV) at 10.00%		1,175,232
Before Tax Summary						
Total Rentable Area		5,900 Sq. Ft				
Total Usable Area		5,200 Sq. Ft				
Total Rental Costs		\$ 2,024,684				
Average Annual Rental Costs		\$ 202,468 per Year				
Average Monthly Rental Costs		\$ 16,872 per Month				
		Rentable Area	Usable Area			
Total Rate		\$ 343.17 Sq. Ft	\$ 389.36 Sq. Ft			
Average Effective Annual Rate		\$ 34.32 Sq. Ft per Yr	\$ 38.94 Sq. Ft per Yr			
Average Effective Monthly Rate		\$ 2.86 Sq. Ft per Mo	\$ 3.24 Sq. Ft per Mo			
Net Present Value at 10.00%		\$ 1,175,232				
Net Effective Rent at 10.00%		\$ 19.92 Sq. Ft per Yr	←	\$ 22.60 Sq. Ft per Yr	←	
		\$ 1.66 Sq. Ft per Mo		\$ 1.88 Sq. Ft per Mo		

Lease Negotiations. Trade-Offs between Landlord & Tenant

In lease analysis the main financial variables that can be manipulated in negotiating a lease are:

- Base Rent and the timing of future escalations
- How future rent escalations are calculated
- Free Rent periods
- Leasehold improvements funded by the landlord
- Leasehold improvement loans from the landlord to the tenant
- Cash payments from the landlord to the tenant for moving costs etc.

Trade-offs can be made. As an example:

Higher starting Base Rent. Offset by:

- Increasing the leasehold improvements provided by the landlord

- More free rent periods

so that the Net Effective Rent for the tenant stays the same.

Primary goals of the landlord

1. High Rent

The landlord wants the lease rate (also called the face rate) to be as high as possible because the lease rate is the major factor that determines the value. When an appraiser is valuing the property they will focus on the lease rate and the renewal rates. It's very unlikely the appraiser will take into account leasehold improvement, free rent periods, and other tenant inducements when valuing the building because these are general historical costs.

2. Good Tenant

Losing a tenant is very costly for the landlord. It may take many months to find a tenant, negotiate the lease and there are many costs involved:

- Loss of rental income
- The landlord has to pay the taxes insurance and maintenance that was being recovered from the tenant if the lease was a triple net (nnn) lease
- Provide costly inducements such as free rent and leasehold improvement allowances
- Legal fees and real estate leasing fee

From a Landlord's and a Tenant's perspective which is the best lease proposal?

Rentable Area: 10,000 Sq. Ft of industrial space

Net Effective Rent Discount Rate: 7.00% before tax

Operating Costs: \$4.00 per Sq. Ft per Yr. increasing at 3.00% per year compounding

Lease Term: 5 years

Discount Rate for calculating the Net Effective Rent: 7.00%

Proposal	Base Rent	Free Rent	Leasehold Improvements	Rent Escalation
A	\$12.00	None	None	None
B	\$13.	None	\$50,000	None
C	\$13.43	6 months Jan & Dec for 3 yrs.	None	None
D	\$10.92	None	None	5.00% per Yr

Which is the best deal for the Landlord _____ Tenant _____

Answer: _____

Net Cash Flow and Net Effective Rent Report

The four options have the same Net Effective Rent of 7.00%

		Project Comparison Report				April 14, 2012
		Landlord Analysis CORFAC Tenant A Proposal Net Cash Flow (Before Tax)	Landlord Analysis CORFAC Tenant B Proposal Net Cash Flow (Before Tax)	Landlord Analysis CORFAC Tenant C Proposal Net Cash Flow (Before Tax)	Landlord Analysis CORFAC Tenant D Proposal Net Cash Flow (Before Tax)	Investor Pro
Year	0	-	(50,000)	-	-	
	1	80,000	92,200	71,917	80,000	
	2	78,800	91,000	70,717	78,800	
	3	77,600	89,800	69,517	77,600	
	4	76,300	88,500	90,600	76,300	
	5	75,000	87,200	89,300	75,000	
	Total	387,700	398,700	392,050	387,700	
Different overall cash flows but same Net Effective Rent						
Before Tax Financial Summary						
Total Rentable Area	10,000 Sq. Ft	10,000 Sq. Ft	10,000 Sq. Ft	10,000 Sq. Ft	10,000 Sq. Ft	
Total Net Cash Flow	\$ 387,700	\$ 398,700	\$ 392,050	\$ 387,700	\$ 387,700	
Average Annual Net Cash Flow	\$ 77,540	\$ 79,740	\$ 78,410	\$ 77,540	\$ 77,540	
Average Monthly Net Cash Flow	\$ 6,462	\$ 6,645	\$ 6,534	\$ 6,462	\$ 6,462	
Average Rent Rates						
Based on Rentable Area						
Average Effective Annual Rate	\$ 7.75	\$ 7.97	\$ 7.84	\$ 7.75	\$ 7.75	
Average Effective Monthly Rate	\$ 0.65	\$ 0.66	\$ 0.65	\$ 0.65	\$ 0.65	
Net Present Value and Net Effective Rent						
Net Present Value (NPV)	\$ 318,621	\$ 318,643	\$ 318,513	\$ 318,621	\$ 318,621	
NPV Discount Rate (Before Tax)	7.00%	7.00%	7.00%	7.00%	7.00%	
Same Net Effective Rent						
Based on Rentable Area						
Net Effective Yearly Rent	\$ 6.37	\$ 6.37	\$ 6.37	\$ 6.37	\$ 6.37	
Net Effective Monthly Rent	\$ 0.53	\$ 0.53	\$ 0.53	\$ 0.53	\$ 0.53	

Since all four options produce the same Net Present Value and Net Effective Rent, which is the best deal for the Landlord and for the Tenant?

Landlord

Wants to maintain the highest base rent which is option C. The following table shows the "Value" of the different lease proposal based on an 8.00% Cap Rate.

Proposal		Value
A \$12.00 per Sq. Ft per Yr.	$\frac{\$12 \times 10,000 \text{ Sq.Ft}}{8.00\%}$	\$1,500,000
B Lease hold improvements \$50,000 \$13 per Sq. Ft per Yr.	$\frac{\$13 \times 10,000 \text{ Sq.Ft}}{8.00\%}$	\$1,625,000
C Free rent 6 months spread over 3 years \$13.43	$\frac{\$13.43 \times 10,000 \text{ Sq.Ft}}{8.00\%}$	\$1,678,750
D \$10.92 per Sq. Ft per Yr. Escalating at 5.00% per Yr.	$\frac{\$10.92 \times 10,000 \text{ Sq.Ft}}{8.00\%}$	\$1,365,000

Landlord. Option C for the Landlord is the best option for the landlord because it produces the highest value when capitalized at an 8.00% Cap Rate.

The landlord wants the lease rate (also called the face rate) to be as high as possible because the lease rate is the major factor that determines the value. When an appraiser is valuing the property they will focus on the lease rate and the renewal rates. It's very unlikely the appraiser will take into account free rent periods and other tenant inducements when valuing the building because these are general historical costs.

The landlord may also prefer Option C because it means giving up two months of free rent each year for three years which costs \$67,150 rather than having to come up with \$50,000 for leasehold improvements.

The landlord has to take into account tenant compatibility and the quality of the tenant.

Losing a tenant is very costly for the landlord. It may take many months to find a tenant, negotiate the lease and there are many costs involved:

Loss of rental income

The landlord has to pay the taxes insurance and maintenance that was being recovered from the tenant if the lease was a triple net (nnn) lease

Provide costly inducements such as free rent and leasehold improvement allowances

Legal fees and real estate leasing fee

From the Tenant's perspective, all four options are financially the same because they have the same Net Present Value and Net Effective Rent.

The best option may depend on the tenant's situation and preferences. As an example:

If they are just starting a business and do not need leasehold improvements they might choose the option with the lowest starting lease rate which is \$10.92 Option C which escalates at 5.00% per year compounding

If they need leasehold improvements they may be willing to pay a higher rent. In this case, the best choice is Option B which provides \$50,000 of leasehold improvements and a lease rate of \$13.00 per Sq. Ft per Yr.

Case Study. Lease negotiations. Landlord Perspective

The landlord has 20,000 Sq. Ft to rent in his 150,000 Sq. Ft industrial building.

The space has been vacant for 5 months and the vacancy rate in the area for similar properties is 12% because of the overall deterioration in the economy which is not expected to change for several years.

Generally, the rental rate in the area for comparable properties is around \$9.00 per Sq. Ft per Yr and the taxes, insurance and maintenance come to \$2.25 per Sq. Ft per Yr and are expected to increase at 3.00% per Yr compounding.

Primary Goals for the landlord:

To rent the space to a financially sound tenant quickly. It's costing the landlord \$27,000 per year or \$2,250 per months for taxes, insurance and maintenance

To maintain the face rate close to \$9.00 per Sq. Ft per Yr

Create the highest possible market value for appraisal purposes by achieving a high face rent rate

Negotiate by offering more free rent, leasehold improvements and other tenant inducements while maintaining a high starting rent close to \$9 per Sq. Ft per Yr.

The table below summarizes the tenant's offer and the landlord's counter proposal.

	Tenant's Proposal	Landlord's Counter Proposal
Base Rent	\$7.50 per Sq. Ft per Yr (NNN)	\$9.50 per Sq. Ft per Yr (NNN)
Contract Term	Ten years	Same
Renewal Rate at end of first five years	\$9.50 per Sq. Ft per Yr	\$10.50 per Sq. Ft per Yr
Recoverable Expenses paid by the tenant	\$2.25 per Sq. Ft per Yr increasing at 3.00% per Yr compounding	Same
Free Rent	Three months First three months of year one.	Six months First two months for three years
Leasehold improvements by landlord	\$150,000	\$100,000 plus a loan to tenant of \$50,000 at 3.00% amortized over 5 years and paid monthly
Moving Allowance	\$0	\$100,000
CPI	Expected to increase at 3.00 per year compounding	
Landlord's Discount Rate for calculating the Net Effective Rent	7.00% before tax	
Result		
Average rent over ten years	\$7.44 per Sq. Ft per Yr	\$8.20 per Sq. Ft per Yr
Net Effective Rent at 7.00%	\$4.80 per Sq. Ft per Yr	\$5.20 per Sq. Ft per Yr

Lease Analysis template: Landlord perspective

Project Info.	Landlord	Leasehold Improvements	Expenses	Revenue	Vacancy	Financing	Termination
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Tenant's Proposal to the Landlord

Landlord. Net Cash Flow & Net Effective Rent (Before Tax)					March 18, 2012	
Fraser Building. Proposal from Tenant					Investor Pro	
Unit 5. 20,000 Sq. Ft. Vacant					Webinar IQ Leasing. Proposal from Tenant	
LANDLORD						
Year	Leasehold Improvements Costs	Financing of Improvements		Operating Cash Flow (Before Tax)	Termination Costs (Before Tax)	Net Cash Flow (Before Tax)
		Borrow	Paid Back			
Year 1 Jan-Year 1 Dec	\$ (175,000)	-	-	\$ 112,500	-	\$ (62,500)
Year 2 Jan-Year 2 Dec	-	-	-	150,000	-	150,000
Year 3 Jan-Year 3 Dec	-	-	-	150,000	-	150,000
Year 4 Jan-Year 4 Dec	-	-	-	150,000	-	150,000
Year 5 Jan-Year 5 Dec	-	-	-	150,000	-	150,000
Year 6 Jan-Year 6 Dec	-	-	-	190,000	-	190,000
Year 7 Jan-Year 7 Dec	-	-	-	190,000	-	190,000
Year 8 Jan-Year 8 Dec	-	-	-	190,000	-	190,000
Year 9 Jan-Year 9 Dec	-	-	-	190,000	-	190,000
Year 10 Jan-Year 10 Dec	-	-	-	190,000	-	190,000
				Total Net Cash Flow (Before Tax)		1,487,500
						Net Present Value (NPV) at 7.00%
						960,426
Before Tax Summary						
Total Rentable Area	20,000 Sq. Ft					
Total Net Cash Flow	\$ 1,487,500					
Average Annual Net Cash Flow	\$ 148,750 per Year					
Average Monthly Net Cash Flow	\$ 12,396 per Month					
Rentable Area						
Total Rate	\$ 74.37 Sq. Ft					
Average Effective Annual Rate	\$ 7.44 Sq. Ft per Yr					
Average Effective Monthly Rate	\$ 0.62 Sq. Ft per Mo					
Net Present Value at 7.00%	\$ 960,426					
Net Effective Rent at 7.00%	\$ 4.80 Sq. Ft per Yr ←					
	\$ 0.40 Sq. Ft per Mo					

Lease comparison report

Compares the Tenant's proposal with the Landlord's counter-proposal.

The Landlord's counter-proposal increases the Net Effective Rent at 7% to \$5.20 from \$4.80 per Sq. Ft per Yr.

Project Comparison Report			
		Tenant's Proposal	Landlord's Counter
Year	0	<u>Net Cash Flow (Before Tax)</u>	<u>Net Cash Flow (Before Tax)</u>
	0	(175,000)	(300,000)
	1	112,500	166,172
	2	150,000	166,172
	3	150,000	166,172
	4	150,000	196,172
	5	150,000	196,171
	6	190,000	210,000
	7	190,000	210,000
	8	190,000	210,000
	9	190,000	210,000
	10	190,000	210,000
	Total	<u>1,487,500</u>	<u>1,640,859</u>
Before Tax Financial Summary			
Total Rentable Area		20,000 Sq. Ft	20,000 Sq. Ft
Total Net Cash Flow		\$ 1,487,500	\$ 1,640,859
Average Annual Net Cash Flow		\$ 148,750	\$ 164,086
Average Monthly Net Cash Flow		\$ 12,396	\$ 13,674
Average Rent Rates			
Based on Rentable Area			
Average Effective Annual Rate		\$ 7.44	\$ 8.20
Average Effective Monthly Rate		\$ 0.62	\$ 0.68
Net Present Value and Net Effective Rent			
Net Present Value (NPV)		\$ 960,426	\$ 1,039,524
NPV Discount Rate (Before Tax)		7.00%	7.00%
Based on Rentable Area			
Net Effective Yearly Rent		\$ 4.80 ←	→ \$ 5.20
Net Effective Monthly Rent		\$ 0.40	\$ 0.43

Increase in the value of the property

How much is the value of the property increased by changing the rent proposed by the Tenant of \$7.50 per Sq. Ft per Yr. to \$9.50 per Sq. Ft per Yr. if the Cap Rate from comparables is 7.00%?

$$\text{Increase in Value} = \frac{(\$9.50 - \$7.50) \times 20,000 \text{ Sq. Ft}}{7.00\% \text{ Cap Rate}}$$

$$= \$571,429$$

This result illustrates how important it is for the Landlord to maintain the face rent as high as possible and offset the higher lease rate by giving the tenant more free rent, increasing the leasehold improvement allowance and providing other inducements such as a contribution to moving costs.

Valuing Land or Ground Leases

Walgreens

Fee simple 75 year ground lease
10% bumps every 10 years
Sold: 5.39% Cap Rate



A land lease is a financial arrangement in which the ground under a structure is leased, rather than sold to the developer. The land and the structure are owned independently.

As an example, the landowner leases the land to a developer for \$150,000 per year for fifty years. The developer builds and operates a shopping center. At the end of 50 years, the shopping center reverts to the landowner.

Another option is that the developer pre-pays the land lease instead of making yearly or monthly payments.

Land leases can be bought and sold which requires the value to be determined. Basically, the buyer is buying a cash flow for a specified period of time.

The Net Present Value (NPV) approach is used to value a land lease as well as Cap Rates.

Example. Valuing a land lease

A land owner has expressed an interest to sell a land lease and wants to know the value of the land lease.

The original lease was for 50 years of which 10 years have passed. The remaining payments are;

Years 11 to 30 \$140,000 per year (20 years)

Years 31 to 50 \$170,000 per year (20 years)

Basically, the buyer is buying a cash flow that ends in 40 years.

Comparable sales of land leases indicates that buyers are looking for a return (Internal Rate of Return) or using a Discount Rate of 12% before tax

The Net Present Value (NPV) of \$140,000 for 20 years then \$170,000 for 20 years at 12% is \$1,177,359

If the buyer of the land lease pays \$1,177,359 they will achieve a 12% (IRR) on the investment

Blending & Extending Leases

In today's economic climate many tenants are facing a decline in sales and profits and are looking at ways to lower costs and one option is to reduce their leasing costs.

On the other hand, a landlord doesn't want to lose a tenant in a tough leasing market nor experience the costs of re-leasing the space which includes commissions, legal fees, providing leasehold improvements, etc.

A potential solution is to "Blend & Extend" the lease.

A blend-and-extend is when a tenant, typically with a few years of remaining lease term, signs an early renewal agreement with the existing landlord to add a few more years to their current lease.

In both cases, the rental rate on the additional term is blended into the existing rate to create a new 'blended rate' often lower than the original.

Example


A company has been paying \$25 a square foot to lease space. It has two years left on the lease, but over time the average effective market rate for that area has dropped to \$18 a square foot. The company renegotiates its lease early and in exchange for committing to 10 more years at the present location, it gets a new lease, blending the two years left at \$22 with the \$16 for the next eight years to determine a new rate.

The impact of a lease on value and marketability

The following example shows the impact of the lease and the marketability of the property.

FOR SALE
PRIME FREE STANDING BUILDING
100% LEASED TO STATE OF CALIFORNIA

\$1,775,000



7.63% CAP RATE

BRAND NEW 8 YEAR LEASE

100% LEASED TO DMV (STATE OF CALIFORNIA)

RECENTLY REMODELED SINGLE TENANT BUILDING

RENTAL INCREASES AND MINIMAL MANAGEMENT

Property & Lease Summary	
Zoning	CO Office Commercial
Parcel Dimension	37,879 Sq. Ft
Building Size	3,814+/- Sq. Feet
Remodeled	Extensively remodeled to 2006 government standards
Current Use	Department of Motor Vehicles (DMV)
Parking	39 spaces. 1 per 100 Sq. Ft
Lease	
Term of Tenancy	The State of California has occupied the building for over 20 years
Lease Term	Brand new 8 year term running through May 1, 2013. The first term of the current lease has 4 years remaining
Tenant Option to Purchase	Tenant has an option to purchase the property after November , 2010 for \$1,850,000 and November 30, 2014 for \$2,000,000
Rent and rental increases	6/1/09 - 5/31/13 \$14,111 per month
	6/1/13 - 5/31/14 \$14,493 per month
	6/1/14 - 5/31/15 \$14,683 per month
	6/1/15 - 5/31/16 \$14,874 per month
	6/1/16 - 5/31/17 \$15,065 per month
CPI Escalator	Each December 1st the Base Rent will be changed by an amount equal to the yearly change in the CPI Index times \$2,463.17
Tenant repayment of loan	\$3,907.79 of the monthly rental payment through 11/30/14 represents the repayment of the \$286,000 loan made to the lessee for alterations and improvements. The loan is amortized over 96 equal payments at 7.50% interest per year

This is a hybrid lease. A Gross Indexed Lease with a very modest escalation clause.

Base Rent: \$44.40 Very high. What if they move out? Appears to included the amortization of leasehold improvements

A major issue;

If there are increases in property taxes, insurance and maintenance only a very small portion of the increases can be passed on to the tenant.

The Net Operating Income (NOI) will decline over time if the increase in property taxes, insurance and maintenance exceed the increase in the CPI.

Tips for reading a lease

Key clauses are often buried in the middle of the lease.

e.g. Demolition Clause

Key Items

1. Who pays what?

What expenses are paid by the landlord and what expenses are paid by the tenant? Which are called:

Recoverable Expenses
 TIM's or TMI's (Taxes, Maintenance & Insurance)
 Additional Rent (Legal term used in leases for recoverable expenses)

Be careful of the term Triple Net or NNN. It is a highly ambiguous term.

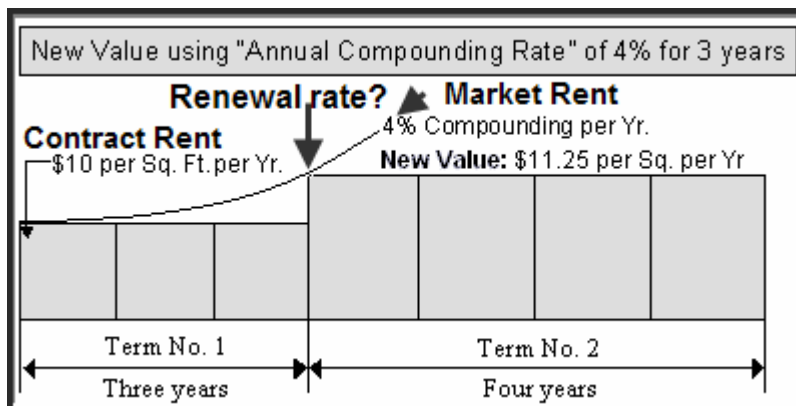
The expenses paid by the tenant to the landlord will be defined in the lease.

2. Under what terms and conditions can the tenant sublease?

3. Lease terms and options to renew

4. The types of lease, the lease rate and how the renewal rates are determined

A standard lease has "Steps" or "Bumps"



How is the renewal rate determined?

- The lease may specify. Example: The renewal rate Feb 2019 is \$25.00 per Sq. Ft per Yr
- At market
- Based on a percentage increase in the CPI (Need to specify which CPI)

5. Read a lease in several settings
6. From an investment analysis perspective, you need to look at all the leases in the building
7. Timing of the lease renewals.

In Diagram A below the lease renewals are spread out, occurring at different times which is less risky for the landlord than if all the lease renewals occur at the same time which is illustrated in Diagram B.

Having the renewals all occur at the same time may place the landlord in a very vulnerable bargaining position particularly if the leasing market is soft and there are many vacancies in the area.

Tenants, knowing that the landlord doesn't want to lose one or more tenants, can bargain hard and make it difficult for the landlord to achieve decent rent increases.

Diagram A. Lease occur at different times

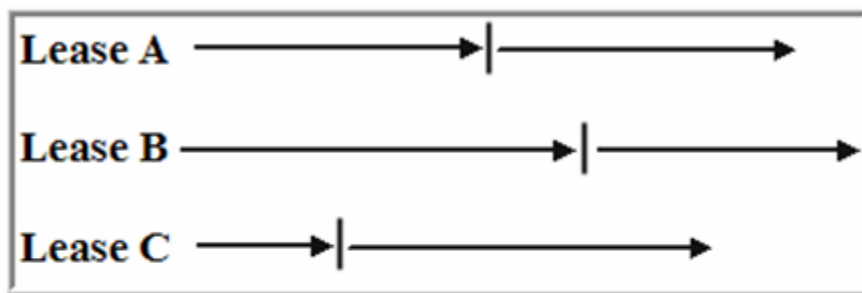
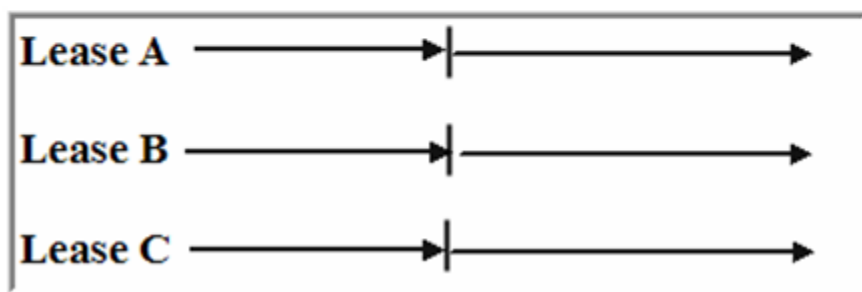


Diagram B. Lease occur at the same time



8. Read with a purpose. Have a question in mind.

Who pay what?

When will the renewals take place?

How is the renewal rate determined?

Is there a demolition clause? If this is important to the landlord or tenant?

Demolition clause

When buying a commercial building which is going to be demolished it is important to check the leases for a "Demolition" or a similar clause which enables the developer to terminate the lease on the issuance of a specified permit or approval from City Hall such as:

Rezoning Permit
Development Permit
Building Permit etc.

Demolition clauses are often included in the lease for building with development potential like these buildings.



Insistence of demolition clause may make it difficult to lease the property. Example.



The iconic corner of Robson and Thurlow that houses two Starbucks diagonally across from each other will be no more as the one that is usually frequented by bikers (below Red Robin restaurant) will be closing at the end of May. The reason, sky high rents and a demo clause that could evict them with only one month's notice.

If it were just high rents it would be surprising that Starbucks, one of the great American success stories couldn't stay open on Robson Street even though rents on Robson for that location would probably be in the \$20,000 a month range. At the end of the day the demo clause was probably the deal breaker.

Developing a Leasing Career

Building Your Support Team. Case study

It is very helpful to build a team of experts you can go to help you lease a property

Case Study

An architectural, engineering & real estate firm was building its own three story office building. They would occupy the third floor and the remaining two floors comprising 6,000 Sq. Ft was available for rent.

There was a "For Lease" sign on the construction site. The development manager was aware that a government agency, the GVRD, was located in several different buildings in the area and instructed one of the salespeople to contact GVRD to see if they were interested in leasing space in the building.

The young commercial sales person response was "what's the point of calling?" Because the GVRD would be aware of the space. With some prodding by his manager, he made called the GVRD and their response was;

1. We have been planning to call you
2. We need 7,500 Sq. Ft and but you only 6,000 Sq. Ft available?

The GVRD was located in three older buildings and were likely overestimating their space by adding up the space they were currently occupying

Solution. The GVRD met with the firm's architect, explained their space requirements. The result was that the 6,000 Sq. Ft met their requirements and they leased the first and second floor.

Tips for Leasing Space

1. When leasing space the initial target market is tenants in the surrounding area. Tenants tend to relocate in the area they are already renting
1. Because you haven't had a call from a local tenant doesn't mean they aren't interested.
2. Potential tenants will drive through the desired area looking for space to rent.
3. Specialize in an area(s) so that you get a lot of signs in the area. That increases the chance that you will be called by tenants scouting the area for space.
4. Specialize
 - a) Geographically
 - b) By property type;
 - Office (downtown, suburban)
 - Industrial
 - Retail
 - c) Each market is very different and requires very different knowledge and skills
 - d) Consider being either a landlord or a tenant rep.
 - e)
 - f) Build a support team
 - E.g. Office leasing
 - Architects, engineers and interior designers
 - Lawyers specialize in leasing
 - g) Contractors specializing in leasehold improvements

Advantages of Leasing as a Career

Leases and subleasing done which can generate a more regular income than investment sales

Marketing is much easier than investment sales. You can put up a "For Lease Sign" and show the space.

The landlord will generally sign a leasing commission agreement

You get to know property owners and may get a listing to sell their building.

A great introduction to commercial real estate and learning the business before moving on to investment sales.

Recommendations

Specialize and focus in a geographic area

Because leases is complex and there are many issues involved that need to be resolved, have the landlord or tenant or their lawyer provide the lease

GOOD LUCK

Analyzing Mutually Exclusive Investments

Mutually exclusive investments are investments where the investor has several mutually exclusive options. They can choose one of the options but not both. Some examples of mutually exclusive investments are:

1. Buy or Lease?
2. Hold or Sell?
3. Personal choice example. I can drive to work or catch a bus but I can't do both

Using the Buy versus Lease as an example, mutually exclusive investments are analyzed as follows:

1. Develop the "Net cash flow" for the "Buy" option
2. Develop the "Net cash flow" for the "Lease" Option
3. Calculate "Net Cash Flow Buy – Net Cash Flow Lease"

This is called the "Differential" or "Incremental Cash Flow" analysis and is a very important concept

Analyzing Buying versus Renting a home. Case Study

Purchase Price: \$700,000

First Mortgage: \$550,000, Interest Rate 4.50%, 25 year amortization

Property Taxes: \$4,500 per year increasing at 4.50% compounding per year

Insurance: \$600 per year increasing at 3.00% per year compounding

Maintenance \$150 per month increasing at 3.00% compounding per year

Utilities: Ignored because the utility costs apply to both buying or renting

Appreciation: 6.00% per year

Analysis Period: 5 years

Buyer's Discount Rate (Desired Return): 10%

Renting

Rent: \$2,200 per month increasing at 3.50% per year compounding

What is the return on the investment?

What is the financial return if we treat the purchase of the home as an investment rather than a “Mutually Exclusive Investment” i.e., ignoring the savings in renting?

Answer: Internal Rate of Return (IRR): 2.88%

Net Cash Flow (Before Tax)						
Buying a home						
Apparent Return on Investment						
Year	Investment	Financing		Operating Cash Flow (Before Tax)	Sale Proceeds (Before Tax)	Net Cash Flow (Before Tax)
		Borrow	Paid Back			
Year 1 Jan-Year 1 Dec	\$ (700,000)	\$ 550,000	-	\$ (43,585)	-	\$ (193,585)
Year 2 Jan-Year 2 Dec	-	-	-	(43,866)	-	(43,866)
Year 3 Jan-Year 3 Dec	-	-	-	(44,144)	-	(44,144)
Year 4 Jan-Year 4 Dec	-	-	-	(44,444)	-	(44,444)
Year 5 Jan-Year 5 Dec	-	-	(483,218)	(44,754)	889,920	361,948
Total						\$ 35,909

Financial Returns (Before Tax) with Financing	
Internal Rate of Return (IRR)	2.88%
Net Present Value (NPV) at 10.00%	(\$ 64,656)
Modified Internal Rate of Return (MIRR)	3.66%
Short Term Financing Rate (Before Tax)	6.000%
Short Term Reinvestment Rate (Before Tax)	1.500%

To get a 10% IRR the price needs to be dropped by \$64,656

Buy versus Rent Analysis using the differential cash flow analysis approach

Net Cash Flow, Buy v Lease (Before Tax)								
Buy vs. Renting a Home								
November 01, 2012								
Investor Pro								
Video Buy vs. Renting a home								
Year	BUY				Sale Proceeds (Before Tax)	Net Cash Flow (Before Tax)	LEASE	BUY v LEASE
	Investment	Financing		Operating Cash Flow (Before Tax)			Leasing Expenses (Before Tax)	Cash Flow Difference (Before Tax)
Year 1 Jan-Year 1 Dec	\$ (700,000)	\$ 550,000	-	\$ (43,585)	-	\$ (193,585)	\$ (26,400)	\$ (167,185)
Year 2 Jan-Year 2 Dec	-	-	-	(43,866)	-	(43,866)	(27,324)	(16,542)
Year 3 Jan-Year 3 Dec	-	-	-	(44,144)	-	(44,144)	(28,284)	(15,860)
Year 4 Jan-Year 4 Dec	-	-	-	(44,444)	-	(44,444)	(29,268)	(15,176)
Year 5 Jan-Year 5 Dec	-	-	(483,218)	(44,754)	889,920	361,948	(30,300)	392,248
Total						\$ 35,909	\$ (141,576)	\$ 177,485
Net Present Value (NPV) at 10.00%						\$ (64,656)	\$ (106,636)	\$ 41,980

BUY v LEASE Financial Returns (Before Tax)	
Internal Rate of Return (IRR)	14.80%
Net Present Value (NPV) at 10.00%	\$ 41,980
Modified Internal Rate of Return (MIRR)	13.72%
Short Term Financing Rate (Before Tax)	6.000%
Short Term Reinvestment Rate (Before Tax)	1.500%

If we paid \$41,980 more for the house the return (IRR) for buying versus renting would be 10%

Conclusion.
 If the Net Present Value (NPV) is positive consider buying.
 If the Net Present Value (NPV) is negative consider Leasing.

Consider Buying if the Total Purchase Price is approximately \$ 741,980 or less.

Results Summary

Approach	Internal Rate of Return (IRR)	Result
Investment Analysis	2.88%	Incorrect
Buy versus Rent Analysis (Differential cash flow analysis)	14.80%	Correct

Buy versus Lease Analysis. Case Study

Buy versus Lease Analysis using the “Differential Cash Flow” approach.

Note. *Buy versus Lease analysis should always be carried out after-tax because of the differences in taxes between buying and leasing.*

Case Study. Buy versus Lease Analysis

An architectural firm is renting 3,000 Sq. Ft. in quality office park development. Their lease will be expiring shortly. The firm has an opportunity to buy the unit they are occupying for \$850,000

Question: Should the architectural firm buy their space or renew the lease?

Investor’s Discount Rate or Desired Return (IRR): 13.00% Before Tax
Marginal Tax Rate: 35%

Note: The project information and details used to carry out this Buy versus Lease analysis can be seen in Appendix No.1 of this manual.

Project Information

Cedar Plaza, Rentable Area: 3,000 Sq. Ft Analysis Period: 10 Years

INVESTOR INFORMATION

Investor’s Marginal Tax Rate: 35.00% Discount Rate: Before Tax 13.00%
Short Term Rates Before Tax for calculating the Modified Internal Rate of Return (MIRR)
Financing Rate: 8.00% Reinvestment Rate: 3.00%

INVESTMENT Land \$300,000 Building: \$550,000 Depreciation Method: Commercial Prop. St. Line

BUY (EXPENSES)

These are the operating costs associated with owning the building such as property taxes, insurance, maintenance etc.

Total Operating Costs: \$7.00 per Sq. Ft per Yr. paid monthly for 12 months then increasing at 3.00% compounding per year

LEASE (EXPENSES)

Cost of leasing instead of buying such as Base Rent, Additional Rent, Parking etc.

Base Rent

\$17.00 per Sq. Ft per Yr. paid monthly. Two terms of 5 years. Increase for the second term based on 3.00% compounding for five years

Additional Rent

\$6.00 per Sq. Ft per Yr. paid monthly for 12 months then increasing at 3.00% compounding per year for the remaining 9 years

Parking

12 spaces at \$30 per monthly for 12 months then increasing at 3.00% compounding per year for the remaining 9 years

FINANCING (BUY)

The financing to buy the property: First Mortgage \$700,000 Amortization: 20 years, Interest Rate 7.50%

SALE INFORMATION

Real Estate Commission: 5.00% of the Sale Price Selling Expenses: \$7,000

Sale Price based on the original investment increasing at 3.5% compounding per year

Net Cash Flow, Buy v Lease (After Tax)							November 05, 2012	
Cedar Plaza							Investor Pro	
Buy v Lease Analysis							Buy v Lease	
Year	BUY			Operating Cash Flow (After Tax)	Sale Proceeds (After Tax)	Net Cash Flow (After Tax)	LEASE	BUY v LEASE
	Investment	Financing Borrow	Paid Back				Leasing Expenses (After Tax)	Cash Flow Difference (After Tax)
Year 1 Jan-Year 1 Dec	\$ (850,000)	\$ 700,000	-	\$(58,403)	-	\$(208,403)	\$(47,658)	\$(160,745)
Year 2 Jan-Year 2 Dec	-	-	-	\$(59,031)	-	\$(59,031)	(48,093)	(10,938)
Year 3 Jan-Year 3 Dec	-	-	-	\$(59,920)	-	\$(59,920)	(48,551)	(11,369)
Year 4 Jan-Year 4 Dec	-	-	-	\$(60,845)	-	\$(60,845)	(49,010)	(11,834)
Year 5 Jan-Year 5 Dec	-	-	-	\$(61,827)	-	\$(61,827)	(49,473)	(12,354)
Year 6 Jan-Year 6 Dec	-	-	-	\$(62,851)	-	\$(62,851)	(50,262)	(7,589)
Year 7 Jan-Year 7 Dec	-	-	-	\$(63,959)	-	\$(63,959)	(51,749)	(8,209)
Year 8 Jan-Year 8 Dec	-	-	-	\$(65,115)	-	\$(65,115)	(53,279)	(8,835)
Year 9 Jan-Year 9 Dec	-	-	-	\$(66,341)	-	\$(66,341)	(55,811)	(9,530)
Year 10 Jan-Year 10 Dec	-	-	(475,068)	(67,832)	1,054,789	511,889	(57,367)	569,256
					Total	\$ (196,402)	\$(524,254)	\$ 327,852
					Net Present Value (NPV) at 8.45%	\$ (299,647)	\$(339,146)	\$ 39,499

BUY v LEASE Financial Returns (After Tax)		
Internal Rate of Return (IRR)	10.57%	←
Net Present Value (NPV) at 8.45%	\$ 39,499	←
Modified Internal Rate of Return (MIRR)	9.85%	
Short Term Financing Rate (After Tax)	5.200%	
Short Term Reinvestment Rate (After Tax)	1.950%	

Buy vs. Lease Differential Cash Flow

Conclusion.
 If the Net Present Value (NPV) is positive consider buying.
 If the Net Present Value (NPV) is negative consider Leasing.

Since the Net Present Value is positive consider buying instead of leasing

Consider Buying if the Total Purchase Price is approximately \$ 889,499 or less.

In the above example, the Investor's Discount Rate or Desired Return (IRR) is 8.45% after tax

Buying compared to Leasing provides an Internal Rate of Return (IRR) of 10.57% after tax. In this example, buying is the better financial option because the Internal Rate of Return of 10.57% after tax is higher than the Desired Return (IRR) of 8.45% after tax..

The Net Present Value can also be used to choose whether to Buy or Lease using the following rules:

1. If the Net Present Value after tax is positive consider buying
2. If the Net Present Value after tax is negative consider selling

Applying the Net Present Value rules to the example above:

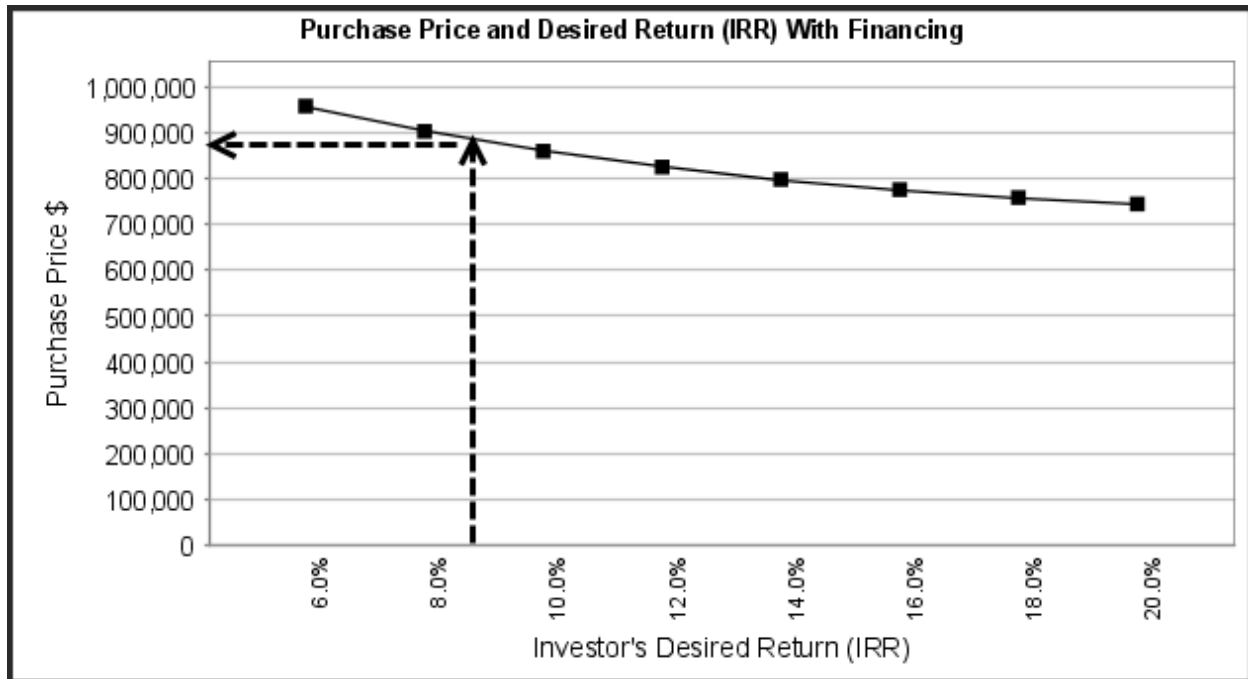
The Net Present Value at 8.45% after tax is +\$39,499 which indicates that buying is the best option from a financial perspective.

Buy versus Lease Graph. Purchase Price & the Desired Return

The graph allows you to determine the maximum purchase that can be paid to achieve the desired return (IRR) after tax from Buying compared to Leasing

As an example, if the Desired Return (IRR) after tax is 8.45% for Buying versus Leasing is then the maximum that should be paid for the property is approximately \$890,000.

If the purchase price is higher than \$890,000 we would be better off leasing.

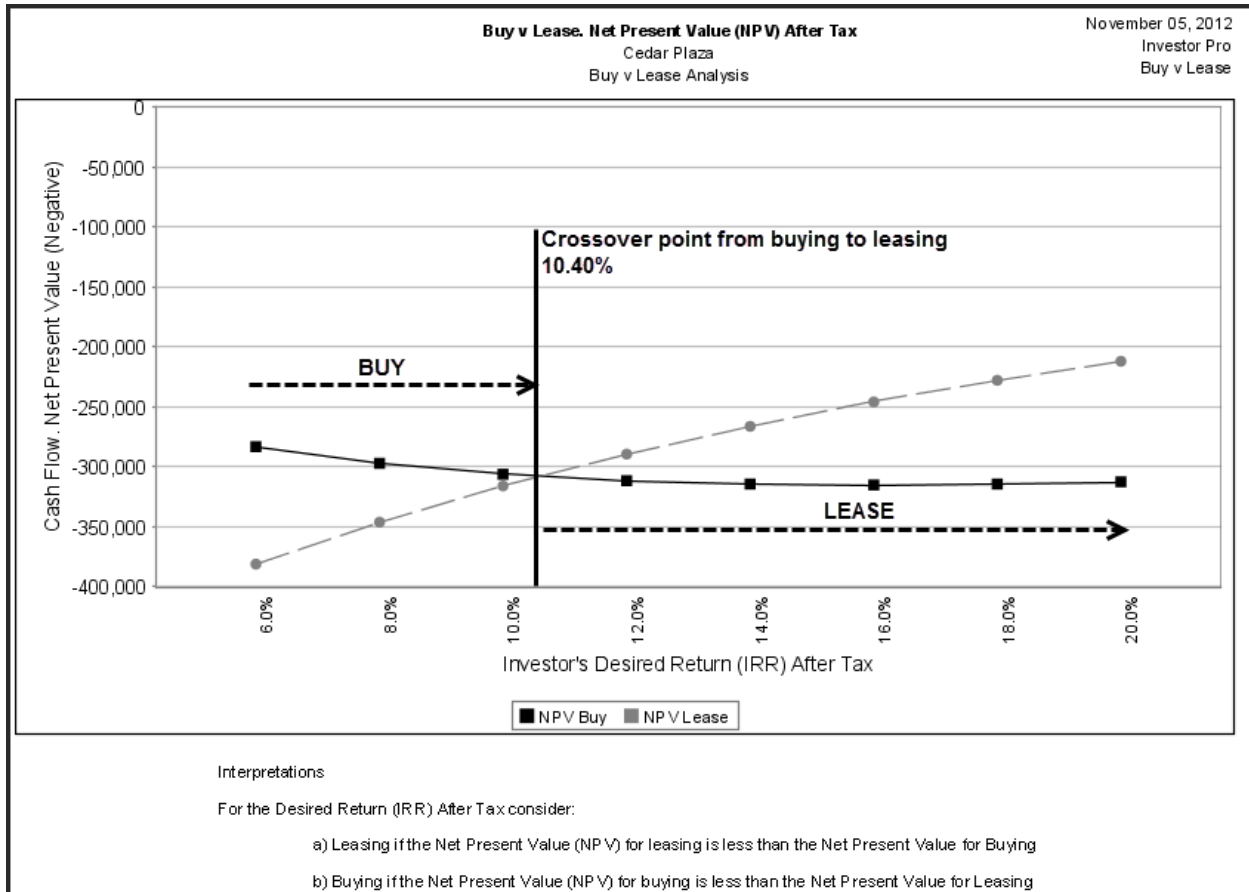


Buy versus Lease Crossover Graph

Shows the cutoff point between buying and leasing.

Up to a Desired Return (IRR) of 10.40% after tax buying should be considered instead of leasing.

As an example, if the buyer can invest their money at 10.40% or more they should consider leasing. If not, they should consider buying.



More examples of the use of differential cash flow analysis

Whenever we are dealing with mutually exclusive investments such as “buy versus lease” we need to use differential cash flow analysis to choose the best option.

Leasing example using differential cash flow analysis

A landlord has 150,000 Sq. Ft to lease and has received the following proposals:

1. Tenant A to rent the 150,000 Sq. Ft
2. Tenant B to rent 100,000 Sq. Ft and Tenant C to rent 50,000 Sq. Ft

The mutually exclusive choices are:

- 1) Rent 150,000 to Tenant A
- 2) Rent 100,000 Sq. Ft to Tenant B and 50,000 Sq. Ft to Tenant C

To decide on the best option;

Develop the Net Flow renting to Tenant A
Develop the Net Cash Flow renting to Tenant B
Develop the Net Cash Flow renting to Tenant C

Calculate Net Cash Flow Tenant A – Net Cash Flow Tenant B – Net Cash Flow Tenant C

If the Net Cash Flow is positive the best choice financially is renting to Tenant A

If the Net Cash Flow is negative the best choice financially is renting to Tenant B and C

Lease Abstract

A lease abstract is the boiled down essence of a commercial lease. It outlines the basic terms contained in the lease so that all parties to the lease can see in plain language what their rights and obligations are. Lease abstracts are especially useful in analyzing property before purchase and are used fairly often by finance companies to get a quick idea of the details of the leases in an income producing property before making an offer of funding.

Some of the common items found in a lease abstract:

- Address of the property or premises

- Lease term including start, end and possession dates

- Tenant and landlord name(s) and contact information

- Description of the premises, unit number, address, etc.

- Amount of base rent for each year of the term and escalations. % Rent

- Amount of additional rent and how calculated (proportionate share, NNN, etc.)

- Parking and signage

- Description of what expenses are paid by whom

- Allowed uses

- Restrictions on alterations

- List of common areas and facilities

- Amount of liability insurance required

- Late payment handling and penalties if any

- Conditions for surrender of premises (remove or leave tenant improvements)

- Outline of tenant improvements paid for by the seller

- Amount of any concessions or inducements

- Detail of renewal options if any and any first rights of refusal for re-leasing space or taking over adjacent space

- Any miscellaneous provisions

Information Sources and web sites

www.investitpro.com Visit the Online Learning Center for educational resources, articles, lease analysis example etc.

Texts

Negotiating Commercial Real Estate Leases. Martin I Zankle
Meta House Publishing
ISBN: 0-940352-14-1
Outstanding book on the legal and practical aspects of leasing

Web Sites

Building Owners and Managers Assoc. (BOMA)

www.boma.org

You can find get a lot of information on leasing and lease terms using Google.

Some good sites are;

www.officespace.com

www.kbalease.com

www.blakes.com

Snagit Screen Capture program www.techsmith.com

Leasing Terms and Definitions

Source. www.OfficeSpace.com/terms.cfm

Absolute Net - Lease requiring tenant to pay in addition to base rent all costs associated with the operation, repair and maintenance of the building, all real estate taxes, and utilities including repair and maintenance of the building's structure and roof. Often the tenant is directly responsible both for all such costs and for the active handling of the items themselves. Distinguished from Triple Net (see below) by tenant's responsibility for maintenance and repair of the building structure and roof.

ADA - Americans With Disabilities Act passed by Congress in 1994 with intent to provide persons with disabilities accommodations and access equal to or similar to that of the general public.

Additional Rent - Any amounts due under a lease that are in addition to base rent. Most common form is operating expense increases.

Agency - Any relationship in which one party (agent) acts for or represents another (principal) under the authority of the latter. Agency involving real property should be in writing, such as listings, trusts, powers of attorney, etc.

Allowance - A set dollar amount provided by the Landlord under a lease to be used by the Tenant for a specific purpose. Examples include allowances for tenant improvements, moving expenses design fees, etc. If the expense exceeds the allowance amount, such excess is the Tenant's responsibility. If the expense is less than the allowance, the savings are retained by the Landlord unless their agreement specifies otherwise.

Alternative Workspace - Term embodies numerous concepts related to utilization of space including telecommuting, hotelling, office sharing and open office plans.

Amortization - Payment of debt in regular, periodic installments of principal and interest, as opposed to interest only payments. May also be used in a lease where the landlord incurs costs for additional tenant improvements which are effectively treated as a debt and repaid by tenant over the term of the lease.

Assignment - A transfer to another of any property, real or personal, or any rights or estates in said property. Common assignments are of leases, mortgages, deeds of trust, but the general term encompasses all transfers of title.

Base Building - The existing shell condition of a building prior to the installation of tenant improvements. This condition varies from building to building, landlord to landlord, and generally involves the level of finish above the ceiling grid.

Base Rent - A specific amount used either as a minimum rent in a lease (retail) which uses a percentage of sales or overage for additional rent or sets a base onto which is added expenses and taxes in a net lease or increases in those items in a fully serviced lease.

Base Year - The 12 month period upon which a direct expense escalation of rent is based. Typically the calendar year the lease commences.

BOMA - Building Owners and Managers Association. BOMA publishes the definition of rentable and useable area, which is used to determine the square footage leased in most commercial office buildings. For more about BOMA definitions,

CAM Charges - Common Area Maintenance charges. Those charges levied on or the expenses incurred in maintaining the common areas of a building.

Churn - Moving people from one workspace to another within the leased premises. Usually involves relocation of furniture, phones, and the like and can be very expensive and time consuming. A high churn rate is to be avoided.

Circulation - Those areas (hallways, corridors, etc.) in an office space that are used to travel between offices, cubicles and the like.

Commencement Date - The date on which a lease begins. This is typically but not always the day on which the tenant takes possession of the leased space, which usually occurs upon substantial completion of the tenant improvements. (See occupancy Date).

Class - Class is usually used in conjunction with an office property and refers to the quality of property. Class definitions fall with the following guidelines. **Class A+**: Landmark quality, high-rise building with prime central business district location (the best of the Class A buildings). **Class A**: Generally 100,000 sf or larger (five or more floors), concrete and steel construction, built since 1980, business/support amenities, strong identifiable location/access. **Class B**: Renovated and in good locations. Newer building are smaller in size, wood frame construction, and/or in non-prime location. **Class C**: Older, un-renovated of any size in average to fair condition.

Common Area - Common area is the area used in common by the tenants of an office building. Common area includes building and elevator lobbies, restrooms and the corridor leading from an elevator lobby to a tenant space.

Contingent Fees - Fees to be paid only in the event of a future occurrence. Examples include: Attorneys (especially in negligence cases) paid based on winning the suit and collecting damages; and a broker's commission paid only upon closing the sale of a piece of property.

Certificate of Occupancy (COO) - A statement issued by a local government verifying that a newly constructed building is in compliance with all codes and may be occupied.

Demised Area - The walled off and secured area of a leased space, separated from spaces leased to others (by a "demising" wall). Also measured as useable area. **Discount Rate** - The rate of interest used in a present value analysis representing the "time value of money".

Effective Rent - The average per square foot rent paid by the tenant over the term of a lease. Takes into account only free rent and stepped rents. Does not include allowances, space pockets, free parking and other similar landlord concessions.

Effective Useable Area - Excludes those areas within the Useable Space (see below) that the tenant pays rent on but effectively cannot use such as columns and sharply angled spaces.

Equivalent Level Rate (ELR) - The ELR is the flat rate per square foot that, if paid each year in nominal dollars, will equal the same total present value as a proposed lease's variable cash flows. The ELR is calculated by discounting all cash flows to a net present value per square foot and then amortizing this lump sum amount evenly over the term of the lease on a cost per square foot basis.

Escalation - A clause in a lease providing for an increased rental at a future time. May be accomplished by several types of clauses, such as: (1) fixed increases -- a clause which calls for a definite, periodic rental increase; (2) cost of living -- a clause which ties the rent to a government cost of living index, with periodic adjustments as the index changes; (3) direct expense -- the rent adjusted according to changes in the expenses of the property paid by the lessor, such as tax increases, increased maintenance costs, etc.

Estoppel Certificate - An instrument which itself prevents individuals from later asserting facts different from those contained in the document. Often required by the buyer of an office building. The tenant and landlord both sign the estoppel certificate, confirming the lease and pertinent facts thereto. Thereafter, neither party may make claims to the contrary.

Exclusive Listing - Any property where the owner has signed an agreement with a real estate broker to lease and/or sell their property. That broker has an "exclusive listing" on the owner's property.

Expansion Option - A right granted by the landlord to the tenant whereby the tenant has the option(s) to add more space to its premises pursuant to the terms of the option(s).

Expense Stop - A fixed amount (typically per square foot) in a lease where the tenant is responsible for all building operating expenses and taxes in excess of said amount.

Extension Option - An agreed continuation of occupancy under the same conditions, as opposed to a renewal, which implies new terms or conditions. In a lease, it is a right granted by the landlord to the tenant whereby the tenant has the option to extend the lease for an ad.

Fair Market Rent - The rent which would be normally agreed upon by a willing landlord and tenant in an "arm's length transaction" for a specific property at a given time, even though the actual rent may be different. In a lease, the term "fair market rent" is defined in a number of different ways and is subject to extensive negotiation and interpretation.

Free Rent - A concession granted by a landlord to a tenant whereby the tenant is excused from paying rent for a stated period during the lease term.

Fully Serviced Lease - A lease in which the stated rent includes the operating expenses and taxes for the building. Same as Gross Lease. Opposite of Net Lease.

Gross Lease - A lease in which the stated rent includes the operating expenses of the building. Same as Fully Serviced Lease. Opposite of Net Lease.

Gross Up - An adjustment made to operating expenses to account for the occupancy level in a building. When operating expenses are "grossed up", it means that the building's variable expenses have been adjusted upwards to the level that those expenses would be incurred if the building was fully occupied (typically 95%).

Ground Lease - A lease of land only, (either vacant or exclusive of any buildings on it). Usually a net lease on a long term basis (30 years+). Ground rent should not be charged back to the tenant as an operating expense.

Hotelling - An alternative workspace concept where rather than having an assigned exclusive workspace, an employee accesses one space, perhaps being one of many such spaces in common with others on an as needed basis, and otherwise works outside of the office.

Hotelling - *(Another usage is what those members of an office relocation committee are entitled to after going through a relocation or office redesign, making use of a commercial shelter offering food, lodging, etc.; preferably in some warm spot like Cancun.)*

HVAC - Heating, Ventilation, Air Conditioning. A general term encompassing any system designed to heat and cool a building in its entirety, as opposed to a space heater.

Landlord (Lessor) - The party (usually the owner) who gives the lease (right to possession) in return for a consideration (rent).

Lease Term - The specific period of time in which the Landlord grants to the tenant the right to possession of real estate.

Lessee (Tenant) - The party to whom a lease (the right to possession) is given in return for a consideration (rent).

Lessor (Landlord) - The party (usually the owner) who gives the lease (right to possession) in return for a consideration (rent).

Letter of Intent - There are potentially multiple uses of this term. Generally a written statement that two parties to a prospective transaction (buyer/seller or lessor/lessee) intend to proceed to a final agreement in good faith on stated principal business terms of the deal to be entered into. This meaning applies when executed by both parties. Alternatively such a document may be signed only by one party and is then an indication of a willingness to enter into agreement on the stated terms and conditions. To avoid legal issues regarding offer and acceptance and thus formation of a binding contract, care should be taken to include a clause stating that there is not a specific offer and no intent to be a legally binding obligation. However, an obligation to continue to negotiate in good faith to conclusion can be created.

Listing Agent - The real estate agent hired by the property owner to lease a property on their behalf. The agent obtains a listing agreement, which calls for that agent to act on the owner's behalf as a fiduciary in leasing the property.

Load Factor - In a lease, the load factor is the multiplier to a tenant's useable space that accounts for the tenant's proportionate share of the common area (restrooms, elevator lobby, mechanical rooms, etc.). The load factor is usually expressed as a percentage and ranges from a low of 5% for a full tenant to as high as 15% for a multi-tenant floor. Subtracting one (1) from the quotient of the rentable area divided by the useable area yields the Load Factor. At times confused with the "loss factor" which is the total rentable area of the full floor less the useable area divided by the rentable area. (If a full floor broken up into multiple tenancies has a useable area of 18,000 s.f. and a rentable area of 20,000 s.f., the load factor is 11.1% and the loss factor is 10%.

Master Lease - A lease controlling subsequent leases. May cover more property than subsequent leases. For example: "A" leases an office building, containing ten offices, to "B". "B" subsequently subleases the ten offices individually. The ten subleases from "B" as sublessor are controlled by the lease from "A" to "B" (master lease).

Net Lease - (See also "Triple Net"). Today this generally indicates a lease in which the stated rent excludes the insurance, utilities, operating expenses and real estate taxes for the building. The tenant is then responsible for the payment of these costs either directly or as additional rent. Opposite of Gross or Fully Serviced Lease.

Net Present Value (NPV) - The calculation of NPV takes into account both the netting of cost and benefits **and** the time value of money. See Present Value.

Net Rentable Area - (Same as Rentable Area). The area (square footage) for which rent can be charged. Generally it is the gross area of the full floor less the area of all vertical penetrations (elevator shafts, stairwells, mechanical shafts etc.) Rentable area can be measured in many ways, but the most common measurement for office buildings is according to BOMA standards. Net Rentable area includes the tenant's premises plus an allocation of the common area directly benefiting the tenant, such as restrooms, common corridors, mechanical and janitor's rooms and the elevator lobby on the tenant's floor.

Non disturbance - So long as lease is not in default, its rights to occupancy under the lease will not be disturbed by the lessor or its successors or assigns.

Occupancy Cost - Any cost or charge incurred by a tenant pursuant to its lease, such as rent, operating expense increases, parking charges, moving expenses, remodeling costs, etc.

Occupancy Date - Unless specifically stated otherwise in the lease, it is the date on which the tenant takes possession of its leased premises. (See also "Commencement Date").

Open Listing - Any property that is leased directly by the owner. Sometimes, the owner will employ an in-house leasing agent. Typically, these are called open listings, where the owner will pay a full commission to any broker who brings a tenant to the property.

Operating Expenses - The cost of operating an office building, such as janitorial, management fees, utilities, and similar day to day expenses, as well as taxes, insurance, and a reserve for replacement of items which periodically wear out. Should not include capital expenses such as roof replacement nor expenses associated with the production of income such as leasing commissions and legal fees.

Owner's Representative - An agent who is an advocate for the owner and/or landlord.

Pass Throughs - An increase in operating expenses over the base year amount that is billed to the tenant as additional rent. See escalation.

Premises - Typically the entire rentable area leased by lessee. Sometimes used to designate solely the useable area leased by lessee, i.e. that for which the lessee has exclusive occupancy as opposed to the common areas.

Present Value - The present value is the amount that must be invested now to produce the known future value. For any sum invested at a given interest rate, the amount one would receive at the end of the period can be determined by taking the investment times one (1) plus the interest rate of the period to the power of the period. For example, if \$10 is invested in an interest rate of 10% for one year, the investment would grow to \$11 at the end of the year. It follows, then, that \$11 one year from now is worth \$10 today; that is \$10 is the present value of \$11.

Reasonable Consent - A standard applied in a lease (most often in a sublease clause) which limits the landlord's ability to withhold consent in its sole discretion. If a reasonable person would give consent to an action given the circumstances, so must the landlord.

Renewal Option - The right of a tenant to renew (extend the term of) a lease for a stated period of time at a rent to be determined (i.e. 95% of "fair market rent").

Rent - Consideration paid for the occupancy and use of real property. Also a general term covering any consideration (not only money).

Rentable Area - The (square footage) for which rent can be charged. Generally it is the gross area of the full floor less the area of all vertical penetrations (elevator shafts, stairwells, mechanical shafts etc.) Rentable area can be measured in many ways, but the most common measurement for office buildings is according to BOMA standards.

Rental Rate - The amount of Rent paid for the occupancy and use of real property. Typically stated on a per square foot per month or per year basis.

Request For Proposal (RFP) - A document typically issued by a tenant's agent to an owner(s) of real property, inviting the owner(s) to submit a proposal to the tenant for the leasing of a vacant space. The RFP sets forth the specific areas of concern to the tenant, such as the space in question, the lease term, expansion and renewal options, rental rate, and tenant improvements and other allowances to be provided by the owner.

Right of First Offer or First Opportunity - A right, usually given by an owner to a tenant, which gives the tenant a first chance to buy the property or lease a portion of the property if the owner decides to sell or lease. Unlike under a Right of First Refusal, the owner is not required to have a legitimate offer which the tenant can then match or refuse. If the tenant refuses to make an offer or if the parties cannot agree on terms, the property can then be sold or leased to a third party.

Right of First Refusal - A right, usually given by an owner to a tenant, which gives the tenant a first chance to buy the property or lease a portion of the property if the owner decides to sell or lease. The owner must have a legitimate offer which the tenant can match or refuse. If the tenant refuses, the property can then be sold or leased to the offeror.

Right of Offset - A specific clause in a lease where the tenant has the right to deduct from the rent certain costs which are due to the tenant from the landlord. Included may be the costs incurred by tenant to cure defaults of the landlord, after notice and failure by landlord to cure the defaults. These are called "self help".

Space Planning - Term is often loosely used. Most often it is the planning of the layout of the interior space of a building to meet the needs of the user. Can also include detailed interior design and preparation of construction drawings. One does not need to be a licensed architect to provide space planning and/or interior design services. Preparation of construction drawings for permit, however, have to be prepared by an architect licensed in the jurisdiction.

Space Pocket - A portion of a leased premises that is set aside to accommodate future growth on the part of the tenant. The space pocket is typically fully improved at the commencement of the lease and no rent is due on the pocketed area until the earlier of "actual use" or a specified future date.

Sublease - A lease, under which the lessor is the lessee of a prior lease of the same property. The sublease may be different in terms from the original lease, but cannot contain a greater property interest. Example: "A" leases to "B" for five years. "B" may sublease to "C" for three years, but not for six years. (Rent can be greater or less than that in the prior lease.)

Subordination - To make subject or junior to.

Substantial Completion - Generally used in reference to the construction of tenant improvements (TIs). The tenant's premises is typically deemed to be substantially completed when all of the TIs for the premises have been completed in accordance with plans and specifications previously approved by the tenant. Sometimes used to define the commencement date of a lease.

Tenant (Lessee) - A holder of an interest in property for a specific term under a lease or other rental agreement (generally a right to occupancy and use).

Tenant Improvements (TI's) - Improvements to land or buildings to meet the needs of tenants. May be new improvements or remodeling, and be paid for by the landlord, tenant or part by each.

Tenant Representative - An agent who is an advocate for the tenant. The relationship is most often the product of a signed representation agreement.

Triple Net - A lease requiring the tenant to pay in addition to a fixed rental, the expenses of the property leases, such as taxes, insurance, maintenance, utilities, cleaning etc. The terms "net net", "net net net", "triple net", and other such repetitions are used.

Turnkey - Referring to an owner making a property ready for a tenant to begin business by having the tenant furnish only furniture, phone and inventory, if any. Turnkey tenant improvements are provided at the landlord's expense according to plans and specifications previously agreed upon by the parties. Unlike an allowance where the tenant pays for costs in excess of the allowance amount, the landlord bears the risk of construction in a turnkey situation.

Useable Area - The secured area (square footage) occupied exclusively by tenant within a tenant's leased space. The useable area times the load factor for common area results in rentable area on which rent is charged. Useable area can be measured in many ways, but the most common measurement for office buildings is according to BOMA standards.

Value Engineering - Process by which costs can be decreased or benefits can be added to an undertaking or project through redesign, prioritization or other similar actions.

Virtual Office - An office that moves with the person. Typically used in a sales organization where the salespeople are given portable computers, modems, and cellular phones in return for having their offices taken away.

Vertical Transportation - Elevators, stairs or escalators moving people or freight between floors in a building.

Work Letter - Specifications for tenant improvements usually attached to a lease and/or letter of intent. The work letter provides the basis for working drawings and contractor pricing and may allocate costs between the parties. Also establishes critical dates for approval of drawings and processes.

Working Drawings - Drawings prepared by a licensed architect and used by contractors in the construction of tenant improvements. Shows all architectural detail such as electric, plumbing, partitions, etc.

Know Your Property Types: Industrial Property

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Industrial property is a broad category encompassing many different types of buildings, each with different characteristics designed to support different business operations. In searching for [industrial for sale](#), [warehouse space](#), [industrial space](#) or [warehouses for sale](#), it is useful to have a basic understanding of the differences between industrial property types.

Here are brief descriptions of eight major industrial property types:

Warehouse/Distribution Buildings

Warehouse/Distribution buildings are very large, single-story structures used primarily for warehousing and the distribution of business inventory. These buildings range from 50,000 to hundreds of thousands of square feet under roof and have up to 60-foot ceiling heights to accommodate extensive racking and storage systems. These buildings may have a small amount of office space as numerous loading docks, truck doors and large surface parking lots to semi-trailers. Some buildings may be served by rail cars.

Manufacturing Buildings

Manufacturing facilities (also called heavy industrial buildings) are designed to house specialized equipment used to produce goods or materials. In addition to providing three-phase high capacity, electric power, these industrial properties may include heavy ductwork, pressurized air or water lines, buss ducts, high capacity ventilation and exhaust systems, floor drains, storage tanks and cranes.

Refrigeration/Cold Storage Buildings:

Refrigeration/Cold Storage are specialized industrial buildings that offer large capacity cold storage and/or freezer space. They are often used as a distribution center for food products that require refrigeration/freezing.

Telecom / Data Hosting Centers

These are highly specialized industrial buildings located in close proximity to major communications trunk lines with access to an extremely large and redundant power supply capable of powering extensive computer servers and telecom switching equipment. These buildings have reinforced floor slabs capable of supporting the weight of the electrical and computer equipment as well as backup generators, and specialized HVAC. They may also include raised flooring to handle cooling and extensive cabling. These buildings may also be called Switching Centers, Cyber Centers, Web Hosting Facilities and Telecom Centers.

Flex Buildings:

This versatile building type (short for "Flexible") covers a broad range of uses and often is used to combine one or more uses in a single facility, including office space, research and development, showroom retail sales, light manufacturing research and development (R&D) and even small warehouse and distribution uses. Because of this versatility, flex buildings are sometimes listed as separate category. Flex buildings typically have ceiling heights under 18 feet and have a higher percentage of office space than larger industrial buildings.

Light Manufacturing Buildings:

Flex buildings can be used for light manufacturing that do not require extensive physical plant and space requirements that heavy industrial buildings provide; such as light assembly.

R&D Buildings:

Flex buildings are popular in high technology industries such as computers, electronics and biotechnology because they effectively support a hybrid of office, manufacturing and warehouse space housed in a single location. Often these types of space users prefer locating in campus-like business parks featuring extensive landscaping, shared architecture design, and lots of surface parking and open space.

Showroom Buildings:

Similar to flex/office buildings in basic construction and layout, showroom buildings combine retail display space with extensive onsite storage and distribution. Typically up to 50% of the interior space in showroom buildings is dedicated to sales.

Biotech (Wet Lab) Buildings:

Biotech buildings are highly specialized flex buildings that support a range of laboratory space where chemicals, drugs or other material or biological matter are tested and analyzed. This type of building requires extensive plumbing and water distribution, direct ventilation and specialized piped utilities. In addition, some may offer accurate temperature and humidity controls, dust control, and heavy power. Often these types of buildings are located together in campus-like fashion with extensive landscaping, extensive surface parking and open space.

Know Your Property Types: Retail Property

Retail Property Comes In All Shapes and Sizes

Did you ever stop to think just how many different types of retail property are available for sale or for lease? There are almost as many different types of retail property for sale and retail property for lease as there are retailers.

Retail property is a broad category encompassing many different types of retail buildings and shopping centers, each with different characteristics designed to support different retail operations. In searching for retail for sale or retail lease, it is useful to have a basic understanding of the differences between various retail and shopping center types.

Community Retail Centers

Community retail centers are a mainstay of U.S. retail activity found in most suburban shopping areas. They typically range in size from 100,000 square feet to 350,000 square feet and offer a wider range of apparel and other soft goods than smaller neighborhood retail centers. Among the more common "big box" or retail anchor store for sale found in community retail centers are supermarkets, super drugstores and discount department stores such as Target or Sears. Community retail center tenants sometimes include value-oriented big-box category dominant retailers selling such items as apparel, home improvement/furnishings, toys, electronics or sporting goods. These shopping centers are usually configured in a straight line (or strip) with extensive surface parking. They may also be built in an "L" or "U" shape, depending on the site and design. Of all the retail property types, community centers encompass the widest range of formats. Certain centers that are anchored by a large discount department store and include a high percentage of square footage allocated to off-price retailers can be termed "off-price centers."

Lifestyle Retail Centers

Lifestyle retail centers are a relatively new addition to the **retail for sale** and [retail space for lease](#) market. Often located near affluent residential neighborhoods, this type of retail property caters primarily to "lifestyle" shoppers, those that enjoy shopping as entertainment or a leisure activity focused on the experience of shopping rather than on convenience or necessity products. Lifestyle retail centers have an open-air configuration and typically include a variety of upscale national apparel and specialty chain stores. They measure between 150,000 square feet to 500,000 square feet. Among the elements that differentiate lifestyle retail centers from other retail space are qualities that make it a multi-purpose leisure-time destination, including upscale or trendy restaurants and entertainment, as well as onsite design elements as fountains, abundant landscaping and outdoor seating areas. These centers may be anchored by one or more conventional or fashion-specialty department stores. A lifestyle center is made up of many of the same tenants as the traditional enclosed mall, however its location, design and accessibility are distinctly different. It is often compared with a "Main Street" retail concept, characterized by a large patronage by local shoppers who visit regularly for shopping or leisure activities, with plentiful parking provided directly in front of the stores.

Neighborhood Retail Centers

Neighborhood shopping centers are designed to provide convenience shopping for the day-to-day needs of consumers in the immediate neighborhood. They are usually located along major commuter routes and other high traffic areas. Most retail property of this type includes a supermarket and many also have a drugstore. A neighborhood retail center is usually configured as a straight-line strip with no enclosed walkways and surface parking facing the stores. They range in size from 30,000 square feet to 150,000 square feet.

Outlet Retail Centers

Outlet retail centers consist primarily of manufacturers' and retailers' outlet stores selling brand-name goods at a discount. The majority of outlet centers are open-air (not enclosed) and configured either in a strip or sometimes with groups of stores clustered in a "village"-type format. They range in size from 50,000 square feet to 400,000 square feet.

Power Retail Centers

Power centers are dominated by several large big-box anchors, including discount department stores, off-price stores, electronics or appliance super stores, warehouse clubs, or "category killers", i.e., stores that offer a vast selection in related merchandise categories at very competitive retail prices. The stores may be connected or freestanding and usually include a minimum number of small specialty tenants. The size of power retail centers range from 250,000 square feet to 600,000 square feet.

Specialty Theme / Festival Centers

One specialty type of retail for sale or retail for lease is the Theme/Festival shopping center, so called because it has a unifying theme that is carried out by the individual shops in their architecture and, to an extent, in their merchandise. Entertainment is often a common element of such centers, and these retail centers are often located in popular tourist destinations. Theme/festival retail centers may be anchored by restaurants and entertainment facilities and often re-use older, sometimes historic, buildings. They range in size from 80,000 square feet to 250,000 square feet and are sometimes included as part of mixed-use developments.

Strip/Convenience Retail Centers

Similar to community retail centers only smaller in size, convenience retail centers (or strip centers as they are sometimes called) feature a row of stores or service outlets managed as a single retail entity, with on-site parking usually located in front of the stores. The stores may be configured in a straight line, or have an "L" or "U" shape. A convenience retail center is among the smallest of shopping centers. They measure 30,000 square feet or less and include a small convenience store anchor such as 7-Eleven or other mini-mart.

Super Regional and Regional Centers

Super-regional and regional retail centers are the largest types of retail centers and include the enclosed mall formats many shoppers are familiar with. A regional retail center includes stores offering a wide variety of shopping goods, general merchandise, apparel and home furnishings. Most are built around a full-line department store with a minimum gross leasing area of 100,000 square feet and may range from 300,000 square feet to more than 1,000,000 square feet. Regional centers in excess of 750,000 square feet GLA with three or more department stores are considered Super Regional retail centers and draw shoppers from a larger population base. Typical configuration is an enclosed mall, frequently with multi-levels. Parking may also be structured to accommodate the sheer size of the center. Super-regional shopping centers range in size from 800,000 square feet and up.
