# Chapter 9

# Income-Producing Properties: Leases, Rents, and the Market for Space

# Property Types

- Residential
  - Single family houses, condominiums, cooperative apartments
- Income Producing
  - Multifamily
  - Commercial
    - Office
    - Retail
    - Hotel/motel
    - Industrial warehouse
  - Recreational
  - Institutional (special purpose)
- Mixed Use Developments

# Supply & Demand

- Equilibrium Market Rental Rate
  - Vacancy Rate
  - Supply and Demand
  - Short run vs. long-run
  - There are different influences on supply and demand for different product types
  - Cyclical markets

# Location & User-Tenants

- Motivating Factors
  - Increase sales
    - Business type where success requires a higher revenue stream and heavy pedestrian traffic
    - (Starbucks on a high-traffic corner; jewelry store)
  - Reduce operating costs
    - Business type where success is based on a lower cost structure and/or large amount of land
    - (Factory outside of city; call center)

# Real Estate Income

- Market Rent *depends on:*
  - Outlook for national economy
  - Economic base of the area
  - Demand
  - Supply
- Vacancy
  - tenant turnover; space is not always leased even in strong markets.

# Why Lease?

- More cost-effective than owning
  - Space requirements
  - Owning is a heavy capital investment
  - Stay out of the “real estate business”
  - Maintain operating flexibility. It’s much easier to lease new space, or sub-lease excess space based on staffing levels than it is to buy or sell buildings.
  - Maintenance and repair
  - If not used, must dispose of excess space

- This results in specialized real estate firms: Owners, but not users.
- The exception is for specialized facilities or for headquarters facilities where there are business reasons to own instead of lease.

# Leases

- Lessor = Owner = Landlord,
- Lessee = Tenant

- Leases are significant, long term financial contracts

- Landlord: Underwriting Tenants
  - Financial statements
  - Credit ratings
  - Analyst reports
  - Bank relationships
  - Existing obligations

# General Contents of Leases (Concept Box 9.1)

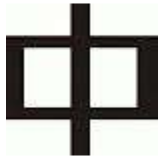
- Parties, Dates, Length
- Base rent
- Deposits, guarantees, LOC *(letter of credit)*
- Condition of space,
- TI's *(tenant improvements)*
- Allowable uses
- Restrictions on assignment or subletting
- Use of common areas and facilities
- Responsibility for maintenance and repair

# General Contents of Leases

- Restrictions on alterations or improvements
- Responsibility for payment of specific expenses by lessee and/or lessor (recoveries/pass-throughs)
- Insurance (both parties)
- Lease renewal options
- Estoppels (certificates)
- Free rent

- Rent quotes normally “per square foot - per year”

Sq. ft. symbol



# Leases & Expenses – many variations

- Gross *(full service or "all bills paid")* leases
  - Tenant pays rent only – simple!
  - Property owner pays all operating expenses
- Modified (full service) lease
  - Specified direct "pass-throughs" (submetering)
  - Non-operating expense "pass-throughs" (taxes and insurance)
- Net Leases
  - with operating expense recoveries
  - See Concept Box 9.2
  - Single net leases, Double net, Triple net
- Terminology: Common Area Maintenance (CAM)
  - Expenses passed through to tenants. This term used especially in retail sector

# Lease Rent Structure

- Flat Rent
  - No rent change over lease term
- Step Up Rents
  - Specified rent increases at specified times
- Indexed Rents
  - Periodic rent adjustment - CPI Index
- Percentage Lease (retail)
  - Rent partially based on sales
  - “Breakpoint”
  - Percentage rents (or overage rents)

# Effective Rent

- Example 9-1:
- Consider the following rent schedule
  - Year 1 = $12/square foot
  - Year 2 = $14/square foot
  - Year 3 = $15/square foot
- Average: $13.66 sq. ft.  Total: $41.00
- Compare to $0/$20/$21 structure
- We need a method to compare different leases
  - Compute present value of rent stream
  - Convert present value to an "equivalent level annuity"
  - We need a discount rate  - let's use 12%

# Effective Rent

- Step 1:  Compute the present value of cash flows, then discount to PV. (using 12%)

| | 0 | 1 | 2 | 3 |
|---|---|---|---|---|
| | | 12.00 | 14.00 | 15.00 |
| Average/yr | $13.67 | | | |
| Total | $41.00 | | | |
| PV | $32.55 | | | |
| Annualized* | | $13.55 | $13.55 | $13.55 |

Excel used to calculate PV of $32.55;
* Annualized by use of annuity (shown next slide).

# Effective Rent

- Step 2: *Spread* the PV back over the rent period as if were an equal annual amount (an annuity):

$\boxed{\textbf{PV}}$ = \$32.55

$\boxed{\textbf{n}}$ = 3

$\boxed{\textbf{i}}$ = 12

$\boxed{\textbf{CPT}}$ $\boxed{\textbf{PMT}}$ = \$13.55

This is the effective rent for this rent schedule.

# Effective Rent

- Compare to the “Free Rent” structure

| | 0 | 1 | 2 | 3 |
|---|---|---|---|---|
| | | 0.00 | 20.00 | 21.00 |
| Average/yr | $13.67 | | | |
| Total | $41.00 | | | |
| PV | $30.89 | | | |
| Annualized | | $12.86 | $12.86 | $12.86 |

# Effective Rent

- Use the same procedure to evaluate all potential lease alternatives.
- This measures the return to the lessor and cost to the lessee
- See Excel spreadsheet example with course materials. (Exhibit 9-7A)

- See Problem 9-3 of text

# What is **NOI** (*Net Operating Income*)

- Property Cash Flow – before debt service
- Hugely important term
- Confusion exists in market
- Different than term used in GAAP
- Similar to the concept of EBITDA in finance

- Even within Real Estate Industry
  - Some deduct CAPEX, some don't.
  - Also issues on TI's and Lease commissions



TI = tenant improvements

# **Pro-Forma** Cash Flow (NOI) **Simplified**

**Gross Rental Income** *(sometimes referred to as **PGI****)*

\- Vacancy and Collection Losses

= **Effective Gross Income (EGI)**

\- Operating Expenses

= **NOI (Net Operating Income)**

* Potential Gross Income

# Pro-Forma Cash Flow (NOI)   More Detail

|  |  |
| --- | --- |
|  | Rental Income (scheduled) |
| + | Other Income |
| + | Recoveries |
| - | Vacancy and Collection Losses |
| - | Concessions (rent reductions, specials etc) |
| = | **Effective Gross Income (EGI)** |
| - | Operating Expenses |
| = | **NOI (Net Operating Income)** |

Some proformas may provide more detail in arriving at Gross Income, or reconciling to PGI.

# Pro-Forma NOI Alternative

Rental Income (scheduled)

\+ Other Income

\+ Recoveries

\- Vacancy and Collection Losses

\- <u>Concessions (rent reductions, specials etc)</u>

= **Effective Gross Income (EGI)**

\- Operating Expenses

\- <u>Capital Expenditures *</u>

**Net Operating Income (“NOI”)**

* Depending on the analyst, capital expenditures may or may not be part of the calculation of NOI. Annualized reserve concept. Sometimes called reserve or CAPEX or capital costs.

# Lease Structures

- Evolve over time
- Sector specific
  - Office
  - Warehouse
  - Retail
  - Apartment

# Office Leases: “Stops”

- Issue is how expenses are passed through
- Recoveries
- Expense “Stops” and “Base Year”
  - Landlord absorbs expenses up to a “stop” amount set when tenant moves in (base year). (Example: $20 base rent rate with a $5 stop)
  - Expense increases (above the stop) in future years are passed through to tenant.
  - See next slide graphic

# Office Leases – Expense "Stop"

# Office Leases: “Rentable”

Rentable area versus Usable area

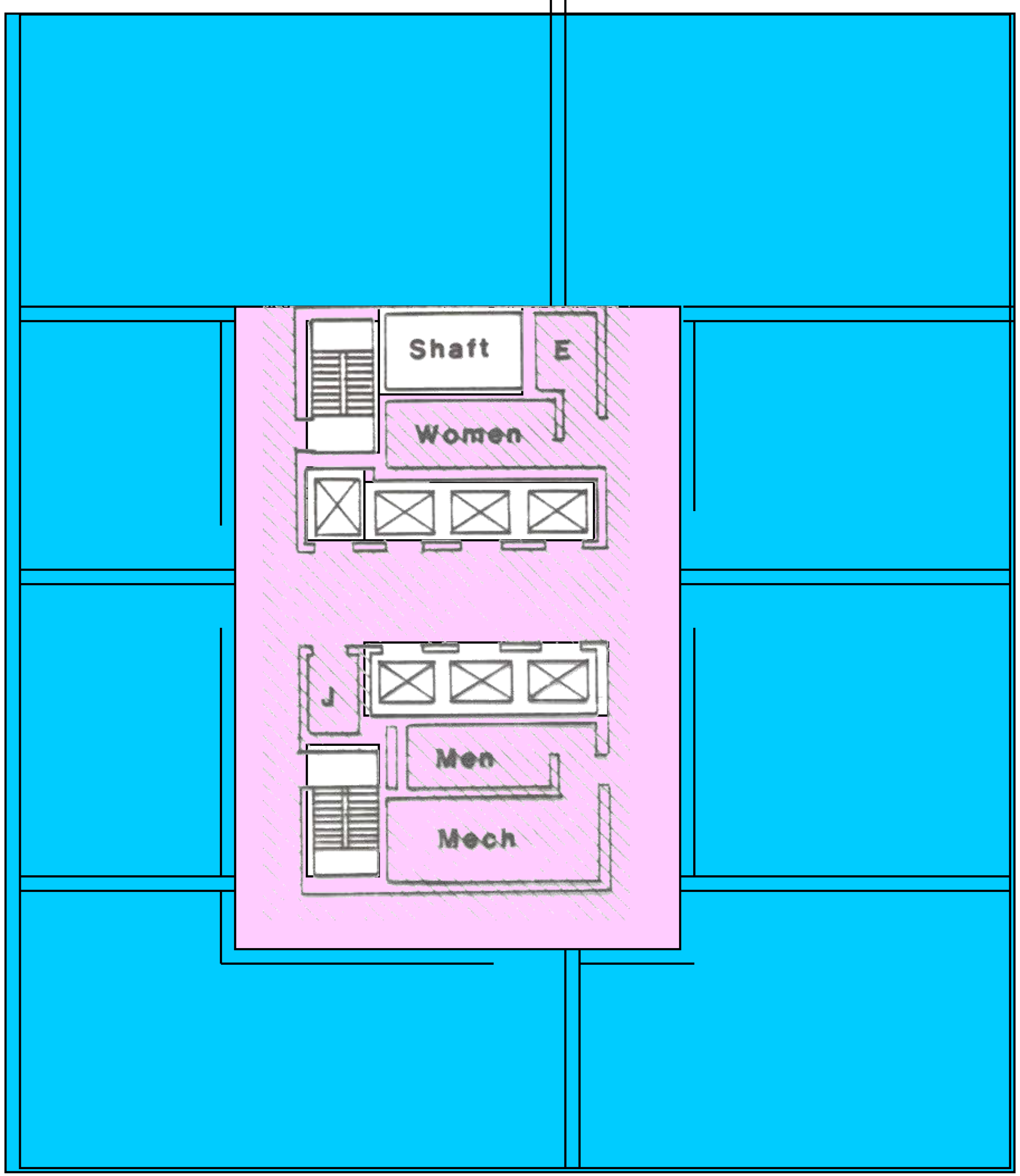
Load factor (or common area or add-on factor)

- Rentable area ÷ Usable area
- Used as a “multiplier” on usable area to convert to rentable area which includes common area space
- Tenant needing exactly 10,000 sq. ft.(useable) may be charged rent on 11,000 sq. ft.
- Referred to as a 10% load (1+10%)
  - Or “load factor” of 1.10

- **Tenant’s Rentable Area** = sum of
  - Tenant’s portion of usable area

  - + pro rata share of common area

  - (including bldg lobby)



# Industrial Property Leases

- Similar to office leases
- More individualized for tenant – may include partial finished space
- Term tends to be longer than office leases
- Tendency for more pass-through expenses.

# Retail Leases:  More complex

- Sales per Rentable Square Foot
- Provisions may affect operations and even include limits on other tenants
- Anchor and In-Line Tenants
  - Rent Differences
- Percentage rent lease
  - Breakpoint
  - Overage rents (different term for percentage rents)
  - Problem 9-5
- Common Area Maintenance (CAM)
  - pass through of expenses

# Retail Leases – Special Terms

- Special lease terms - Concept Box 9.4
- Kick out (termination) clause
  - If sales psf are low, landlord (sometimes tenant) can terminate the lease
- Co-tenancy clause
  - If a specific anchor “goes dark”, tenant has right to terminate/renegotiate lease
- Signage – specifications for this
- Exclusivity
  - No similar retailers allowed in center
- Operating hours

# Retail Leases

- Complex
- Special provisions
- % Rents
- CAM negotiations
- Merchant associations

Concept Box 9.4 p287 and proforma p288

# Apartment Leases

- Shorter Term
- Impact of consumer protection laws
- Gross Potential Rental Income
  - Full occupancy
- “Loss to Lease” see proforma Ex. 9-12
  - Leases made in prior periods may have been made at “below market” rents. If gross potential rental income is projected using current rates, an adjustment is needed to account for the gap to establish Gross Rental Income.
  - Rents usually referred to/quoted on a “per month” basis. Absolute $/unit ($1,500/unit).
  - Owners may think of rent in per square foot terms. So if the unit was 1,000 sq. ft., rent would be ($1.50 psf).

# Suggested problems

- P9-3
- P9-4
- P9-5