Lease Analysis

1. Lease types

I. Rent side:
   - Flat Rental Lease:
     - 5-year term
     - $10/SF
     - No adjustment in between
   - Graduated Rental Lease:
     - 3-year term
     - $10/SF for the first year
     - $12/SF for second year
     - $15/SF for the third year
     - Adjustment is based on pre-specified amounts
   - Indexed Lease:
     - 3-year term
     - The first year rent is $10/SF
     - Adjusted by CPI rate for the next two years
     - Can use any index, such as a local rental index
     - Can use any amount of adjustment, such as 50% of the CPI
     - Adjustment is based on a pre-specified index
   - Reevaluation Lease:
     - 3-year term
     - At the end of the third year, the contract will be extended for 3 more years
     - The rent will be determined by the market rate at that time.
     - How to determine the rent?
       - Who?
       - How?
       - Costly.
       - Will have arguments
     - Not very popular
     - Adjustment is based on a pre-specified method
   - Percentage Lease:
     - Base rent: $3/SF, regardless of the total revenues of the tenant
     - Percentage rent: 1% of the amount of total revenues that exceeds $1 million
     - Issues:
       - Costly
       - Privacy
       - Why do it?
     - Anchor tenants
       - Risk sharing
       - Alignment of interest of the owner and tenants
     - Mixed adjustments (base and percentage)
   - Understand risk and return trade-off relationship:
     - Flat rental lease: no adjustment
Graduated rental lease: fixed amount
Indexed lease: fixed index
Reevaluation lease: fixed method
Percentage lease: mixed adjustment

- Why do we use different types of lease?

- Rent concession:
  - One-month free rent for a one-year contract
  - Why not just reduce the rental rate by (1/12)?
  - Remember the cash rebate strategy used by car dealers?
  - Signal aspects of the contract

- Escalation clauses
  - Rent will be increased by $0.1/SF if the actual amount of property tax exceeds $1/SF
  - Can also use labor and/or utility costs as the reason for adjustments
  - Minimize the uncertainty on both sides

- Renewal option
  - 5-year lease
  - Rent is $8/SF per year
  - At the end of the 5th year, the tenant has the option to renew the lease at 10/SF for another 5 years.
  - Or to have the option to rent more space in the same property
  - Why does the tenant want to use this strategy? (Type of tenant with high moving costs such as restaurants.)
  - Why does the owner want to use this strategy?
  - Both the current and future rents will be higher than normal

- Purchase option
  - Rent is 10/SF for one year
  - Tenant has the right to purchase the property at $60/SF at the end of the contract
  - Rent can be counted as part of the purchase price
  - What is the benefit of the contract?
  - Uncertainty on the tenant side: to stay or not to stay
  - Both the rent and the price will be higher than normal

- Escape clauses
  - 5-year lease
  - Rent is 10/SF for one year
  - Tenant has the right to cancel the lease at anytime during the lease term
  - Uncertainty on the tenant side: start-up company, explore the market
  - The amount of initial improvement is a key in the negotiation
  - The rent will be higher than normal

- Tenant improvements
  - Carpet, wall, ceiling, lightings, etc.
  - Who should pay for the tenant improvement? owner or tenant?
  - Depends on the duration (and type) of the lease
  - $3/SF tenant allowance (retro-fit) might be the solution

II. Expenses side:
  1. NNN: tenant pays all expenses
  2. Expense stop: $3 stop
• Owner pays expenses up to $3/SF
• Tenant pays the rest if the actual amount is larger than $3/SF
3. Full service: owner pays all expenses
4. Combinations: such as N and NN structures
5. Understand the risk and return trade-off relationship:
   • To sign a NNN lease at $9 rent per SF.
   • To sign a full service lease at $12 rent per SF.
   • To sign a lease with $12 rent and $3 expense stop per SF.
   • You project that the expenses will be $2, $3, or $4 per SF (with 1/3 probability each).
   • The expected expenses, therefore, will be $3 per SF.
   • Rank your three alternatives
2. Potential Gross Income (PGI)
- Scheduled rent (contract rent): occupied space
- Escalation income:
  - From expense stop leases
  - From escalation clauses
- Other income:
  - Parking fee
  - From vending machine
- Market rent:
  - From vacant space
  - Need estimate absorption schedule
  - Difficult to do

3. Vacancy and Collection Losses (VAC)
- Including vacancy, turnover, and nonpayment of rent
- Type of property: hotel, office, apartment
- Quality of the tenant
- Local economic conditions: supply and demand

4. Operating Expenses (OE)
a. Fixed expenses: do not vary with occupancy level
- Real estate taxes
- Insurance
- Management fee:
  - Only for small projects
  - Such as apartment with 50 units
- Utility:
  - Very difficult to determine
  - Non-linear function
  - Large base
b. Variable expenses: vary with occupancy level
- Management charges
- Leasing fee
- Utility
  - Electricity
  - Water
  - Sewer
  - Heat
  - Air-conditioning maintenance
- General payroll
- Cleaning
- Decorating (public area)
- Security
- Garbage and pest control
- Office supplies
- Tenant improvement (new tenant)
C. Repair or replace a roof? Tax implications

5. Sources of Data
1. History of the property (pro forma statement): be careful
   • Deferred maintenance (maintain and repair equipments)
   • Capital improvement needed
   • Improper capitalization of expenses
   • No provision for vacancy and collection losses
   • Special concession in leases
   • Bona-fide tenants
   • Management duties performed by investors.
2. Management firms in the area
   • Compare to the data of similar properties
   • See if the pro forma statement of the property is abnormal
   • Compare to the average for identifying superior (or inferior) performance
3. In-house data on similar properties
   • Provide limited information
   • Still provide good information if no other sources available
4. Published data
   • Provide an average of a big market
   • Your property might be better (or worse) than the market
5. Recent signed leases
   • Current rental rate might differ from contract rates (past events)
   • The best indicator for extracting the expectation of future rents (look at the growth rate)
   • Especially important for properties with high vacancy rates
6. Vacancy level of similar properties
   • Depends on (current and future) supply-and-demand conditions of the market
   • Past occupancy levels might not be relevant in a dynamic market
   • A very important factor to determine the value of the property
7. Pay attention to taxes and utilities
   • Cannot be determined by past trends
   • Cities decide the taxes based on their budgets
   • Utility companies determine rate based on pre-determined returns