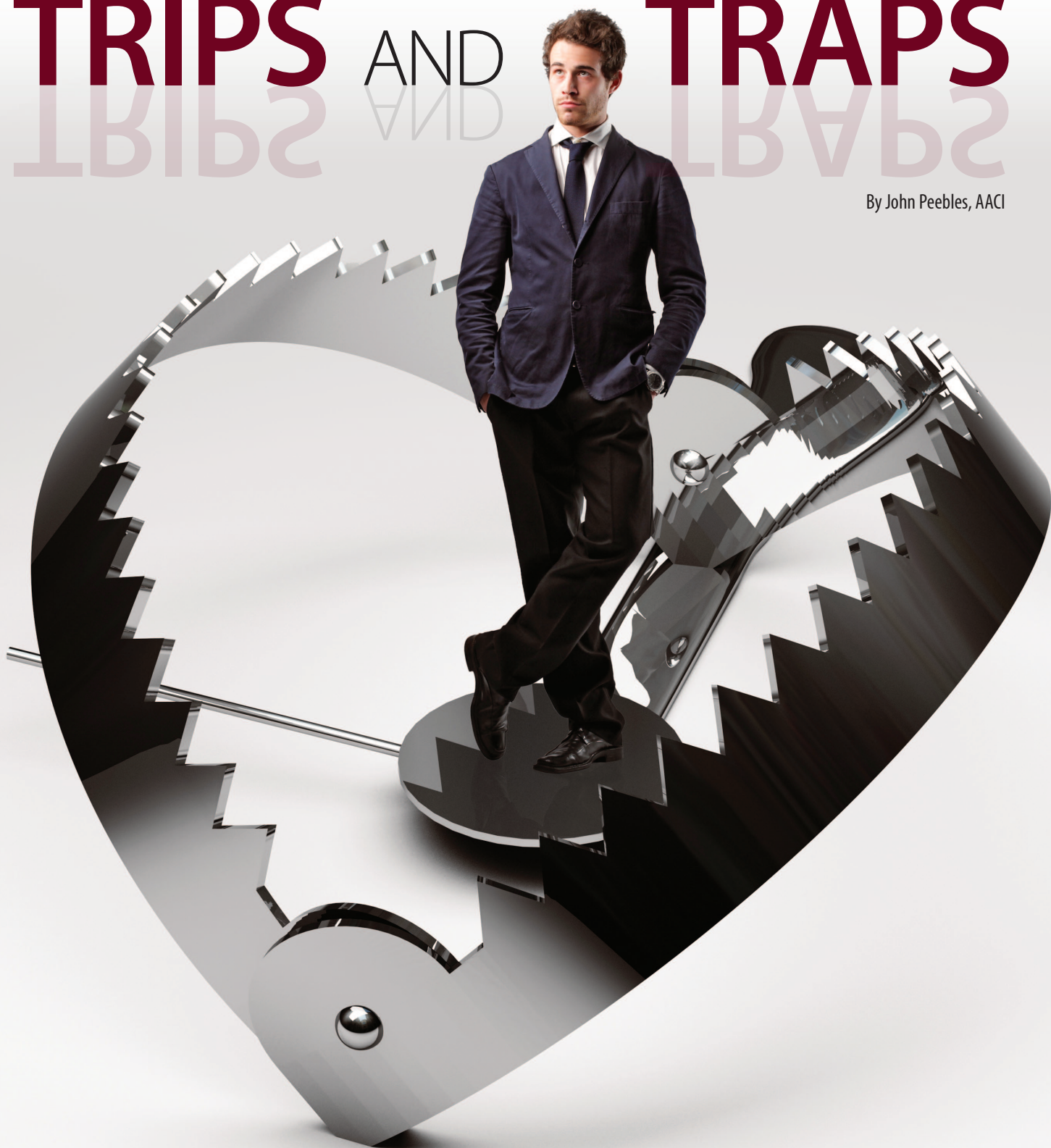


Commercial lease analysis

TRIPS AND TRAPS

By John Peebles, AACI



Analysis of the commercial lease agreement is the core of IC&I appraisal and value added consulting work. Yet, the problem appraisers face is the pressure to trade-off the due diligence required for thorough lease analysis with the need to produce valuation advice to clients at the ever-increasing speed of business.

My goal in this article is to offer tips for appraisers to reduce the risk of errors in lease analysis by avoiding some common traps and still achieving a manageable balance between research and report production.

First, let's accept that no one is perfect. We have all made mistakes in lease analysis and I am willing to put up my hand up first. The key is whether we learn from our mistakes, grow from our experiences, and continue to advance our professional development. In my career in the public and private sectors, I have seen all types of lease agreements, from the back of a napkin and handshake deals in the Cariboo-Chilcotin to a Sears 100+ page department store lease. I have hired appraisers and reviewed their appraisal reports, some the size of a phone book. Believe me, size does not matter when comes to appraisal reports.

Here are the most common lease analysis errors that I have encountered.

1. Reliance on the rent roll or lease abstract without a review of the lease documents.

This may seem like a no-brainer. Relying only on the rent roll is high risk and contrary to the direction in our education program, standards and every appraisal text. However, a review of lease agreement may not be practical when dealing with a large business park or office building with 30+ lease agreements.

In cases where you are dealing with an overwhelming volume of lease documents, you need to apply the 'reasonable appraiser' test. The test is pretty simple. Talk to five or six appraisers who value this property type and ask them what level of due diligence they feel is appropriate — this will be your research benchmark. A common sense approach I have used is to rely on a combination of sources: rent

roll, lease abstracts, sample lease documents and advice from the property manager. This approach should be adequate when valuing a building with fairly uniform lease documents. In other scenarios, you may find the building has a combination of semi-gross and net leases reflecting the landlord's efforts to move tenants to contemporary net lease agreements as leases roll-over. My advice in this scenario is to quote a decent fee — there is a lot of work in reviewing documents and adjusting all rents to net for consistent analysis.

2. A belief that the lease consists of only one document.

Did you know that the lease is actually a number of documents including the original agreement, addendums, modification agreements, assignments, and other documents that modify the lease terms? When you contact the landlord or property manager for the building leases, ensure you ask for all

the related documents. You will also want to see Offers to Lease (a conditional contract) for new deals that have not yet been solidified in a formal lease agreement.

Some appraisers may feel that a lease abstract or detailed summary of the lease is sufficient for valuation purposes. Here is the problem with this shortcut. Unless the landlord has a very competent lease administrator, there is a risk that the information recorded in rent rolls and lease abstracts will not agree 100% with the actual lease documentation. In addition, the lease abstract may not identify all the lease clauses that impact value.

Landlords may also relax rent or other lease conditions through an informal letter to the tenant. I recently valued a large commercial centre and assumed the landlord provided all the lease documents. However, the rent for a specific CRU noted on the rent roll did not agree with the lease agreement. I questioned the landlord and learned that the rent for this



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CRU had been reduced by an informal letter for a 12-month period in recognition of the tenant's struggle with sales. The intention of the parties was for the rent to return to the contract level for the remainder of the term. However, I would not have accounted for the short-term income loss and subsequent value impact if I had not questioned the landlord.

3. Assuming that lease renewal, assignment, and termination clauses are boilerplates that require no interpretation.

Lease renewal provisions impact the appeal of a property to investors, its re-development potential, and, ultimately, market value. Consider this example. You are valuing a commercial strip plaza in Brampton, Ontario with eight CRUs and a freestanding restaurant. You examine the CRU leases and two things stand out: (1) the CRU leases rolled over in 2008–2010, and (2) the landlord has granted each of the tenant's options for 1–5-year renewal. The rents for about one-half of the CRUs appear below market.

Are there risks associated with this scenario? On the surface, it appears that the tenant has shifted market risk to the landlord, since the landlord has effectively eliminated the option of re-leasing CRU space occupied by under-performing tenants. While the loss in potentially achievable rent is somewhat mitigated by the reduced risk of tenant vacancy, most landlords want their assets performing at market levels. It is understood that you will value the strip plaza using market rent for each CRU, but you also need to recognize the lease-up costs in getting to market rent and a potential 5+–year delay, using either a lease-up expense or overall cap rate adjustment.



4. Failure to understand and recognize the distinction between assignments and sub-leases.

An assignment is the legal transfer of the lease contract by the lessee (the assignor) to another party (the assignee) willing to assume the lease. When a tenant completes a lease assignment, the assignee becomes bound to all the terms and conditions of the lease. The parties (landlord and new tenant) will sometimes use this opportunity to negotiate modifications to the lease agreement, such as renewal options and rent escalation. In contrast, a sub-lease is created where the tenant transfers only a portion of their leasehold interest to a third party. The landlord retains a legal contract with the tenant, but has no legal relationship with the sub-tenant. In general, a sub-lease creates greater risk for the landlord than an assignment, because of a lack of control over the sub-tenant, particularly the sub-tenant's covenant or ability to pay rent.

A building with multiple sub-leases,

expected to be more common as economic conditions decline, is a significant market risk. The landlord has likely played no role in pre-qualifying the sub-tenants. If the sub-tenants cannot pay the rent, the landlord still has recourse to the tenants – but they may have left the local area, adding to the cost of collections. A simple clue to missing lease documentation is when you learn that the business occupying the leased premises is different from the party who signed the lease agreement – red flags go up!

5. Failure to understand the connection between rentable area and rent.

Rent is typically defined in the lease as all the money owed by the tenant to the landlord for occupation of the demised area. Rent includes 'base rent' for the rentable area and 'additional rent,' the tenant's share of the building expenses and other charges such as property taxes, insurance and management fees.

What if the landlord has recently engaged a

space measurement firm to accurately measure the building's common and useable areas? The report identifies a building rentable area that is 6,000 square feet larger than the total of the rentable area in all building leases. The landlord provides the report and instructs you to rely on it for valuation purposes, since it instantly boosts the overall value of the building. The problem with the landlord's instructions is that the contract rentable area and related monthly, annual, and square foot rents in the lease agreements will continue to be the legal basis for rental income. The potential bump in rent associated with the corrected measurements cannot be achieved until the lease is modified or renewed. Using the space measurement numbers for your appraisal report would be misleading to any intended user and result in an incorrect value estimate.

6. Terminology confusion.

Leases can be defined and described according to the calculation of rent (flat, step-up, percentage, revaluation) and method of expense recovery (gross, semi-gross, triple-net or net, absolute net). In the 'good old days,' or as my daughter would complain. . . "when you, mom, and dinosaurs roamed the earth," commonly used lease terms were single-net, double-net, or triple-net rent. A single-net lease implied payment of base rent plus property taxes. A double-net lease required payment of base rent, property taxes and building insurance, while a triple-net lease meant payment of base rent, property taxes, insurance, and building repairs and maintenance.

The world has now moved on and these terms are beginning to fade from our lexicon. There are two contributing factors: (1) each lease is unique — meaning great variability in expenses that are included, and (2) the general desire of landlords to recover virtually all building operating expenses from tenants, meaning a preference for absolute net leases.

Analysis errors will occur when relying on rent comparables that are identified in MLS listings as absolute net, when the rent is based on a different expense recovery formula. If a broker describes the rent as absolute rent, one way to confirm the degree of net is to ask them to confirm this statement: "you mean the tenant pays for all expenses and structural repairs and the landlord has no non-recoverable expenses?" You also need to deliver a clear and concise valuation report to clients and others who will rely on your report. A good practice is to define potentially confusing real estate terms, such as lease jargon, in the glossary of your report, in order to avoid costly confusion.

7. Failure to understand the motivation of the parties.

As an appraiser, I am always curious how the parties arrived at the lease deal — were the negotiations long and difficult, or routine? I have found that the outcome of a lease deal can often be explained by understanding the motivation of the parties.

Landlords want tenants with a good covenant, who will keep the premises in good repair and be compatible with other tenants. Landlords also want to minimize cash outflows

for lease incentives such as free rent periods, fixturing allowances, caps on operating cost escalation, and rights of lease renewal. Tenants want pretty much the opposite and focus on total costs of occupancy along with environmental risks. Prevailing market conditions during lease negotiations will determine who has the upper hand in the tug of war that results in the lease deal. If you are privy to the motivation of the parties (brokers will often share this information), you have a better chance of understanding lease terms that appear unusual or unexpected. Here are some examples.

- A prospective retail tenant who is attempting to lease space in a community shopping centre will likely be motivated by the potential for a successful business enterprise in the centre rather than retail space which is available for the most competitive rent.
- In contrast, a medical practitioner seeking suburban space with good parking and access to major routes may have many leasing options and the overall cost of occupancy will be a major factor in the final decision to lease space.
- In a more unusual case that I have encountered with a lease termination clause, the owner of a small service commercial property with re-development potential decided that he did not want to commit to a five-year term with a new tenant. Conversely, the tenant was uncertain whether the new premises and location would be a good fit for his business. In this case, both parties had mutual interests and negotiated an early termination clause that either party could trigger after the first 12 months of the term, by giving six months written notice.

In summary, please learn from some of these common mistakes and avoid the lease analysis traps. To reduce your risk in lease analysis, first ensure you understand the basics of commercial leasing; then ensure you have all relevant lease documents. Know which parts of the lease documents deserve the most attention; and finally, ensure you pose follow-up research questions to landlords, property managers and brokers.



From traps to opportunities

Increasing your lease analysis skills will pay off in other ways. Have you considered how you can add value to your valuation or consulting advice to clients by offering an analysis of their leased commercial assets in relation to the market norms?

One opportunity for a value added service for building owners is typically associated with older office and retail properties. As discussed above, you may find that the common area apportioned to the tenant only covers floor rentable area (*BOMA 1980 Standard*) and the landlord can increase 'recovery income' upon lease renewal using the *BOMA 1996 Standard*. Under *BOMA 1996*, additional common

areas like lobbies and mechanical rooms are allocated to tenants, meaning the landlord can recover a much higher percentage of operating expenses as leases rollover. The *BOMA 2010 Standard* provides new treatment of storage area, floor common area, and additional space measurement options for landlords.

There is no dispute that leases are legal contracts. Interpretation and drafting of lease agreements and clauses is typically the domain of the legal profession. However, you can still offer your expert opinion on value implications of lease clauses and terms. This advice extends beyond the scope of what most legal professionals can offer clients. Landlords, property managers and tenants

can benefit from your opinion on appropriate term of lease, lease incentives, risks associated with lease clauses, and clauses that should be re-negotiated at renewal, before giving instructions to legal counsel. 📊

End notes

¹ The City of Brampton with a population of 450,000+ is part of Greater Toronto. According to City economic development sources Brampton has 19,586,750 ft² of retail space.

² It would be appropriate to comment in your report that the building has been re-measured and there is potential for rent upside in the short-term.

Further reading

I have assembled a small, annotated bibliography and web-links that readers may find useful in expanding their lease analysis skill-set.

- UBC Sauder School, *CPD 109 Commercial Lease Analysis*, updated to 2011.
http://www.sauder.ubc.ca/Programs/Real_Estate_Division/Credit_Programs_and_Professional_Development_Courses/Professional_Development_Courses.
This two-part CPD course is available as a live webinar or through self-study.
- Harvey Haber, *The Commercial Lease: A Practical Guide*, 4th edition, *Canada Law Book*, http://www.iciworld.net/html/haber_pg.htm.
Haber is the Canadian authority on commercial lease agreements.
- Robert Wickett and Monica Klimo, *Problems Encountered by Tenants: Occupation, Use, Enjoyment of Premises*.
http://www.mackenziefujisawa.com/News_Articles/Robert_Wickett-Commercial_Leasing_Disputes.pdf.
Disputes between landlords and tenants commonly arise over use and occupation of the premises.
- Appraisal Institute of Canada and Appraisal Institute (US). 2010. *The Appraisal of Real Estate (3rd Canadian Edition)*. Vancouver: UBC Real Estate Division.
Chapter 6: Real Property Ownership and Interests Chapter 21: Income and Expense Analysis
- Building Owners and Managers Association (BOMA) International. 2010. *Standard Method for Measuring Floor Area in Office Buildings*. New York: BOMA International.
- Real Property Association of Canada website: www.realpac.ca Leasing terminology summarized here: <http://www.realpac.ca/terminology/>
- The Commercial Leasing Blog. <http://leaselaw.wordpress.com/a-note-on-comments/> Interesting US blog on a variety of leasing issues
- Mark Fredrick and Denis Rivard, *The appraiser in commercial lease disputes*, *Canadian Property Valuation Magazine*, Vol. 51.2 (2007).
- John Busey Wood, *Navigating the Dangerous Shoals of a Commercial lease for Beginners*, Thomson and Knight LLP, 2009.
<http://www.lulu.com/product/paperback/navigating-the-dangerous-shoals-of-a-commercial-lease-for-beginners/16299762>.
Well known New York commercial real estate lawyer with extensive lease resources available on homepage.
- Commercial Leasing: pitfalls and pratfalls http://www.nelligan.ca/publications/e/Commercial_Leasing.pdf
A good, easy to read legal summary of the key issues encountered by landlords and tenants in drafting lease agreements.