# Leases and Leasing Strategy

Commercial property leases are fundamental to real estate investment. They create the operating cash flow that determines property value. A lease is a long-term contract between a property rights holder (lessor/landlord) and a user (lessee/tenant).

Leasing has become the dominant way commercial space is occupied the US, especially for larger, more valuable properties in the institutional real estate investment industry.

# Why Leasing Exists

## Tax Advantages

Income tax circumstances of tenants and landlords create potential for tax arbitrage, saving taxes across property investors and tenants.

## Specialized Expertise

Development and management of built space have become specialized industries with economies of scale.

## Centralized Control

Single landlord ownership enables optimization of property functioning as a whole, especially in retail centers.

## Risk Management and Capital Retention for Tenant

Leasing addresses heterogeneity in market knowledge, credit access, and preferences for real estate risk exposure. **Note also Capital Retention: For many companies, the return on capital from investing in their own business is higher than the return on capital if they owned real estate.**

# Basic Lease Typology: Expense Responsibility

## Gross Lease

Landlord pays all operating expenses. Also called full-service lease. Most popular for office properties.

Landlord provides services like electricity, heat, water, cleaning, maintenance, and security.

## Net Lease

Tenant responsible for operating expenses. In triple net (NNN), tenant pays nearly all expenses including property taxes and insurance.

Popular for single-tenant retail and industrial properties where expenses are easily attributed.

## Hybrid Lease

Tenant and landlord share operating expenses. Common in apartments where some utilities are separately metered.

May include expense stops, where tenant pays expenses above a specified level.

# Types of Rent Changes in Leases

## Flat Rent

Fixed, constant rent throughout the lease term. Common in short-term leases and during low inflation periods.

## Graduated Rent

Specified step-ups in rent at predetermined times. Example: $15/SF with $1/SF increase every two years.

## Revaluated Rent

Professional appraiser determines rent adjustments at specified times. Common in very long-term leases.

## Indexed Rent

Rent adjusted according to public index like CPI or PPI. Example: 75% of CPI increase applied annually.

## Percentage Rent

Used in retail spaces. Rent includes base amount plus percentage of tenant's sales revenue.

# Lease Characteristics Affecting Value

## The Space

Location, physical qualities, size, shape, and configuration determine usefulness and rent. Rent per square foot is typically minimized for most commonly demanded space sizes.

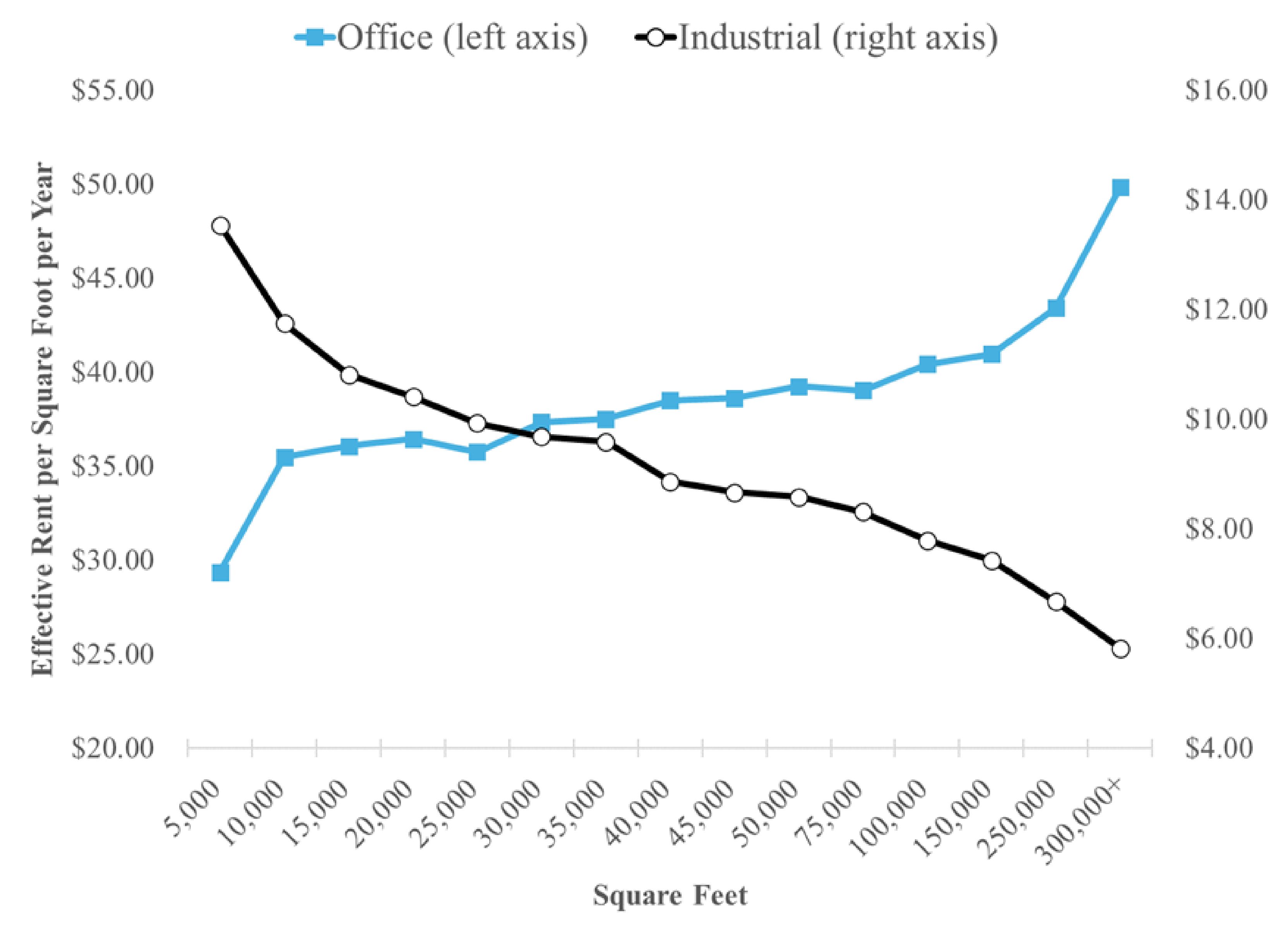
## The Tenant

Credit quality, prestige, synergy with other tenants, and parking use intensity affect desirability. High-profile tenants may bring particular benefits to landlords.

## Lease Terms

Length of lease, timing of signing and expiration, rent levels, concessions, covenants, and options all impact value to landlord and tenant.

# Rent Variation by Space Size for Office Rent




Office rents typically increase with space size as larger spaces are often custom-built and have fewer options in the market. Industrial properties show the opposite pattern, with rents decreasing as size increases.

Industrial properties are typically built on city outskirts where space isn't limited, while office buildings have structural constraints that make larger spaces more expensive to construct.  Thus, industrial rents are more linear with size.

# Lease Options

### Renewal Option

Tenant can renew at end of lease at specified or market rent. Similar to right of first refusal when at market rate.

### Cancellation Option

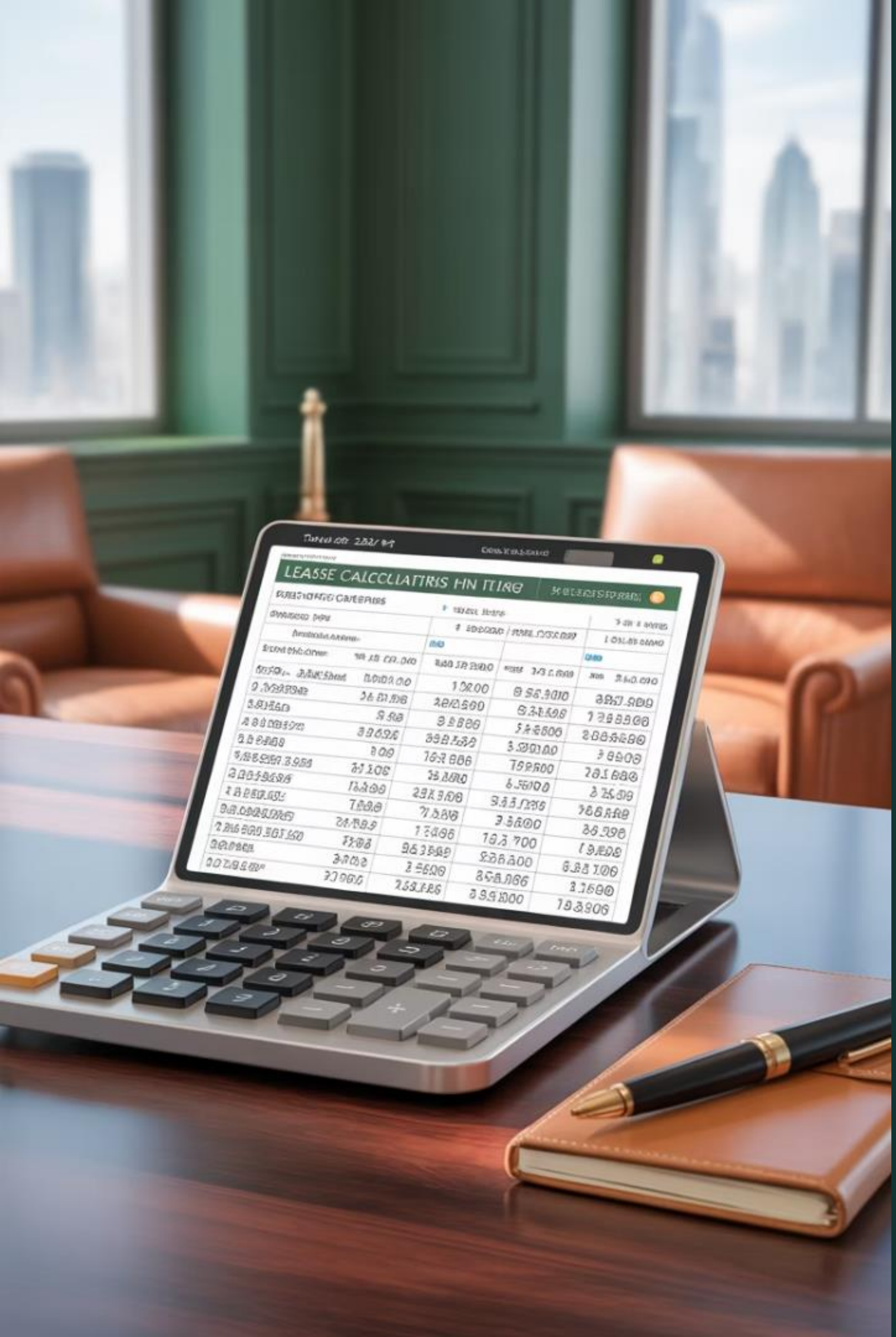
Allows option holder to cancel lease before term end with specified notice. May benefit either landlord or tenant.

### Expansion Option

Gives tenant right to take additional space, either as first refusal on adjacent space or at specified rent during time window.

### Sublease Rights

Tenant's ability to sublet space unless explicitly limited. Provides flexibility but landlord may want control over new occupants.



# Effective Rent Calculations

## Calculate Lease Present Value (LPV)

Sum the discounted cash flows over lease term. First payment often undiscounted as leases typically pay in advance.

$$LPV = CF_1 + CF_2/(1+k) + CF_3/(1+k)^2 + \ldots + CF_t/(1+k)^{\wedge}(T-1)$$

## Determine Annualized Value

Calculate equivalent level annuity payment of the LPV. This creates the Annuitized Lease Value (ALV).

$$\text{Effective Rent} = (LPV) \times k(1+k)/[1-1/(1+k)^T]$$

## Choose Appropriate Discount Rate

For rigorous calculation, use tenant's credit rating and bond market yield curve rather than conventional 10% rule of thumb.

# ALV Numerical Example

| Lease A | Lease B |
|---|---|
| 5-year term | 6-year term |
| $20/SF net rent | $24/SF net rent |
| 1-year free rent upfront | 2-years free rent upfront |
| Landlord ALV: $15.44/SF | Landlord ALV: $14.90/SF |
| Tenant ALV: $25.74/SF | Tenant ALV: $25.21/SF |

Using a 7% discount rate for landlord and 8% for tenant, Lease A is preferable for the landlord while Lease B is better for the tenant. The final agreement depends on negotiation success and market conditions.

ALV calculations help compare lease alternatives but don't capture all strategic considerations that might make a seemingly less favorable lease the better choice.

# Broader Leasing Strategy: Term Length

### Releasing Costs

Vacancy, search costs, and tenant moving expenses create deadweight costs that generally push both parties toward longer leases.

### Expiration Timing

Landlords may prefer staggered expirations to reduce exposure to market conditions at any single point in time.

### Market Expectations

Expectations about future rent trends affect opportunity costs. Rising rent expectations require higher ALVs for longer leases.

### Flexibility Value

Shorter leases provide flexibility to adapt to changing market conditions or space needs, valuable under uncertainty.

# Typical Lease Terms by Property Type

### Hotel: 1 day-1 week

Lowest releasing costs and highest flexibility needs.

### Apartment: 1 year

Low releasing costs and high flexibility value.

### Small Retail: 2-5 years

Moderate releasing costs and flexibility needs.

### Office: 3-10 years

Moderate to high releasing costs.

### Anchor Retail: 5-15 years

High releasing costs, lower flexibility needs.

### Industrial: 5-20 years

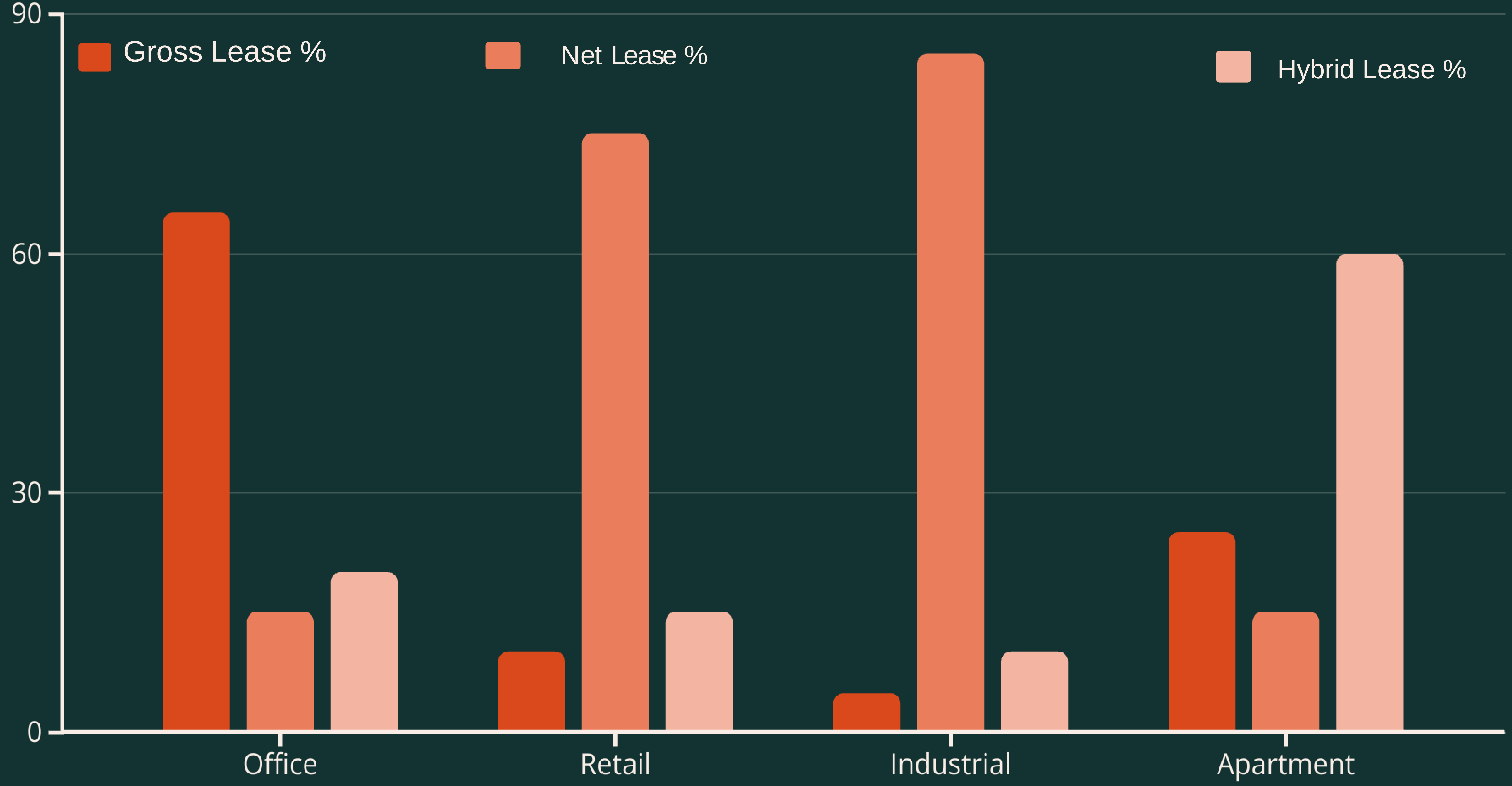
Highest releasing costs, lowest flexibility value.

### Unique Corporate Space: 20+ years

Extremely high releasing costs or owner-occupancy.

# Lease Distribution by Property Type

Office properties predominantly use gross leases due to difficulty attributing expenses in multi-tenant buildings. Retail and industrial properties favor ne
net leases, especially with single tenants. Apartments typically use hybrid leases with some utilities separately metered.



# Renewal Options at Market Rent

## Not Just a Right of First Refusal

Even "at market" renewal options have value to tenants and cost to landlords beyond simple right of first refusal.

## Tenant Holdup Problem

Landlords might exploit tenants with high moving costs by demanding above-market rent at renewal without this protection.

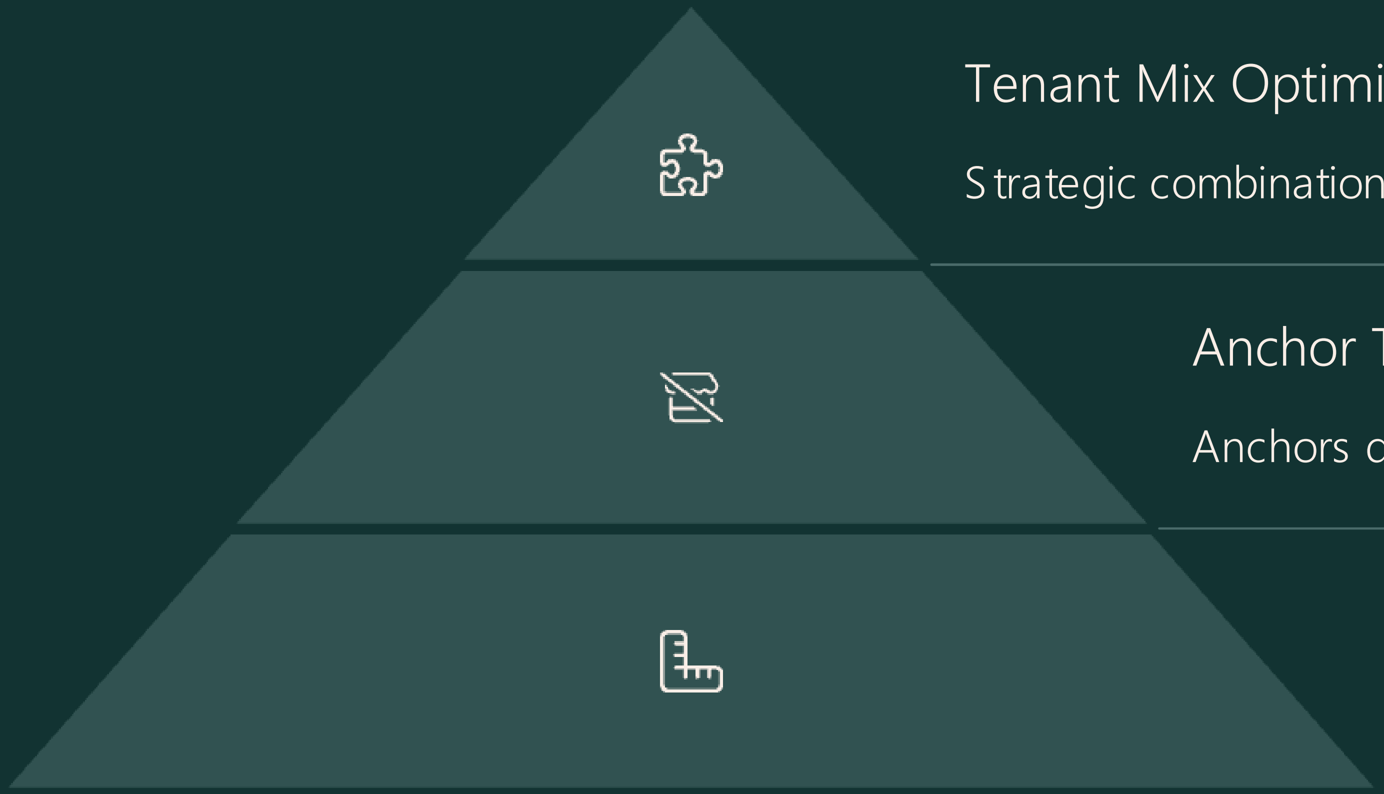
## Landlord Holdup Problem

Tenants can block redevelopment plans by exercising renewal options, potentially costing landlords significant value.

## Market Equilibrium

The value and cost of renewal options are typically reflected in agreed rent and other lease terms.

# Micro-spatial Trade-Offs and Synergies



### Tenant Mix Optimization

Strategic combination of tenants creates value beyond individual rents.

### Anchor Tenant Benefits

Anchors draw customers and add prestige, creating positive externalities.

### Optimal Space Configuration

Archetypical space sizes balance efficiency and market demand.

Clever mixing of tenants and space configurations can significantly enhance property value. Landlords may rationally offer lower ALV to tenants tenants that create positive externalities for other tenants.

Anchor tenants often receive favorable terms because they generate value for the entire property. This explains why shopping centers may short leases with options to continuously optimize tenant mix.

# Why Percentage Rents in Retail?

## Incentive Compatibility

Percentage rents give landlords direct incentive to help maximize store revenues through optimal tenant mix and center management.

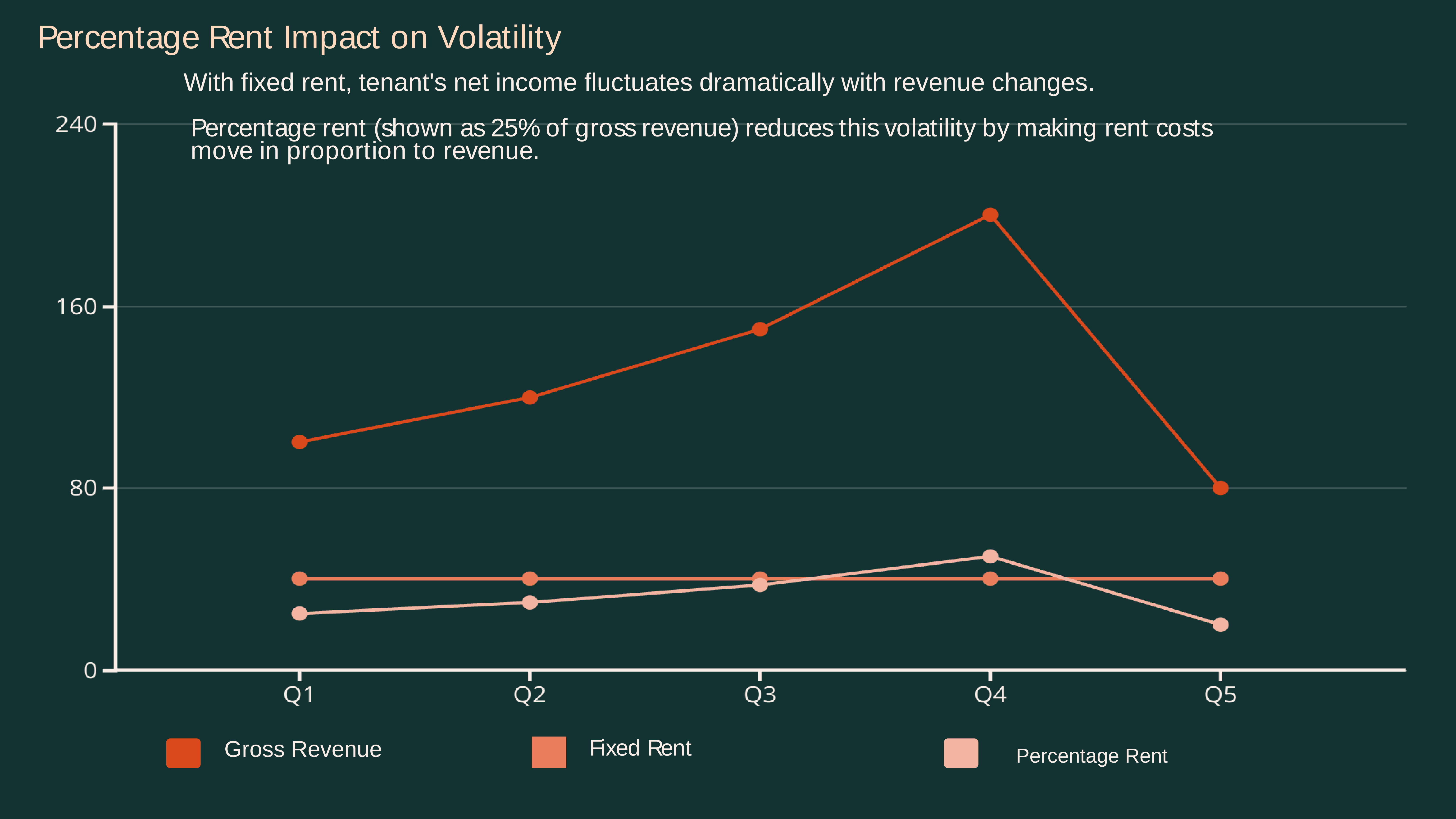
Without this alignment, landlords might not optimize for tenant success.

## Risk Reduction

Small retail businesses are sensitive to fixed rent leverage. Percentage rent reduces this effect by making rent proportional to revenue.

Landlord becomes like an equity partner, sharing in tenant's operating risk and growth.


The balance between fixed base rent and percentage components can be adjusted based on tenant financial strength and potential for positive externalities.


Percentage Rent Impact on Volatility
With fixed rent, tenant's net income fluctuates dramatically with revenue changes.
Percentage rent (shown as 25% of gross revenue) reduces this volatility by making rent costs move in proportion to revenue.
240
160
80
0
Q1
Q2
Q3
Q4
Q5
Gross Revenue
Fixed Rent
Percentage Rent

# Why Concessions Instead of Lower Rent?

### Tenant Cash Flow Timing

Up-front concessions ease tenant moving or start-up expenses, matching rental expenses with revenue generation timing.

### Strategic Cash Flow Timing

Higher future cash flows may facilitate building sale or loan refinancing if these events are likely in the future.

### Information Privacy Value

Concessions are more private than quoted rent, concealing from other tenants and competitors exactly how low the effective rent is.

### Market Perception

Maintaining higher quoted rents preserves perceived property value even when effective rents are lower due to concessions.

# Optimal Landlord Search for Tenants

### Set Asking Rent

Establish initial asking rent above expected transaction rent to allow negotiation room.

### Evaluate Tenant Quality

Consider credit quality, business stability, and potential synergies with existing tenants.

### Negotiate Terms

Balance rent level with concessions, term length, and options based on tenant quality.

### Adjust Strategy

Modify asking rent or concessions based on market response and vacancy duration.

Landlords must balance the cost of continued vacancy against the benefit of waiting for a better tenant or higher rent. This optimal search problem involves weighing immediate income against long-term property value.

# Expectations and Lease Term Structure

### Market Rent Expectations

Rising rent expectations create upward-sloping term structure; expectations create downward

### Market Sector Norms

Specific submarkets develop characteristic lease terms based on these trade-offs.

### Releasing Cost vs. Flexibility

Optimal lease term balances costs of finding new tenants against value of flexibility.

### Expectation Alignment

Complementary expectations facilitate agreement; conflicting expectations may require shorter terms.

# Key Leasing Strategy Takeaways

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### Major Lease Types

Gross, net, and hybrid leases distribute operating expenses differently between parties.

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### Rent Change Methods

Flat, graduated, revaluated, indexed, and percentage rents serve different strategic purposes.

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### Term Length Factors

Releasing costs, market expectations, expectations, flexibility value, and expiration timing drive optimal terms.

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### Typical Lease Durations

From daily hotel stays to 20+ year industrial leases, each property type has characteristic terms.

Understanding lease structures and strategies is fundamental to real estate investment and property management. The optimal approach balances financial considerations with strategic property positioning.

Effective leasing strategies must consider both immediate financial impacts and long-term property value implications.