

What You Should Know About CRE Leases

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WHAT YOU SHOULD KNOW ABOUT CRE LEASES

Commercial real estate leases are the lifeblood of the commercial real estate industry. And yet, leases are complex and often confusing, even for veteran commercial real estate professionals. In this eBook we will discuss commercial real estate leases at a high level and then review several common lease components.

The Spectrum of Commercial Real Estate Leases

First of all, let's take a look at the spectrum of commercial real estate leases, which describes the universe where all CRE leases exist. At a high level, this is how you should think about commercial real estate leases.

All commercial real estate leases fall somewhere along a spectrum with absolute net leases on one end and absolute gross leases on the other end. Most leases fall somewhere in the middle and are considered a hybrid lease.



When most people talk about a triple net or NNN lease, they are usually thinking about an absolute net lease. Likewise, when people talk about a full service or gross lease, they are usually thinking about an absolute gross lease. However, just

because a lease is called or labeled an NNN lease does not mean it's actually an absolute net lease. The same is true for full service leases, which are not always an absolute gross lease. Often a lease will be called a "triple net lease" or a "full service lease" for convenience when in fact the terms of the lease say otherwise.

For example, when a building is brand new the tenant may indeed be responsible for funding replacements such as the roof or HVAC systems as they wear out over time. However, on older buildings a lease can often be called triple net, but actually require the landlord to fund these capital expenditures over time, rather than the tenant.

The Most Important Thing About Leases

So, this brings us to **the most important thing to remember when working with commercial real estate leases, which is to ALWAYS read the lease.** This point cannot be overemphasized. The only way to truly understand the terms and conditions of a lease is to actually read the lease. Simple labels like triple net, full service, or modified gross, which are commonly used by brokers and landlords, will often conflict with the actual terms of the lease.

How to Calculate Square Footage

One of the first steps in evaluating a commercial property is determining the total rentable square feet. While this might seem like a straightforward calculation, it unfortunately doesn't always end up being so simple. This is particularly true for multi-tenant buildings. In this section we'll go over how to calculate rentable

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square feet (RSF), usable square feet (USF), and the load factor, then we'll tie it all together with a clear example.

Usable Square Feet

In a nutshell, usable square footage is the actual space you occupy from wall to wall. Usable square footage does not include common areas of a building such as lobbies, restrooms, stairwells, storage rooms, and shared hallways. For tenants leasing an entire floor or several floors, the usable square footage would include the hallways and restrooms exclusively serving their floor(s).

Rentable Square Feet

Rentable square footage is your usable square footage PLUS a portion of the building's shared space. As mentioned above, shared space can be anything that is outside of your occupied space and is of benefit to you (lobbies, restrooms, hallways, etc). As a tenant in a commercial space, you pay for a portion of the shared space and thus your monthly rent is always calculated on RSF.

The increase in the rentable square footage above your usable square footage is referred to variously as the "load factor," "common area factor," or "add-on factor." This is generally in the 10-15% range and can be higher in some buildings. When evaluating commercial real estate space options, you'll want to be aware of this factor so you know exactly what you're getting and what you're paying for.

How to Calculate Load Factor

Calculating the load factor is pretty straightforward. First, find out how much total floor area a building has. Then, subtract the shared square footage to determine the usable square footage. The owner or owner's agent should be able to give you these numbers. Then divide the total floor space by the USF to get the load factor.

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Rentable Square Feet Load Factor

Example: A 100,000 square foot building has 15,000 square feet of shared space. The usable square footage is 85,000 square feet. The load factor would be 1.176 ($100,000 / 85,000$). That would also be the same as saying the building has a load factor of 17.6%.

Rentable Square Feet vs Usable Square Feet Example

Let's look at a quick scenario when comparing load factors and rentable square footage to see why it's useful.

The situation

A tenant is looking at two different office spaces, both with 5,000 square feet of usable space and the exact same rental rates, but differing load factors.

Option A

The first suite has 5,000 usable square feet and has a 20% building load factor for an additional 1,000 sf ($5000 \times 20\%$) of rentable space. Thus, the rentable square feet is 6,000 square feet.

Option B

The second office has 5,000 usable square feet and a 15% load factor. The rentable square footage is 5,750 sf ($5,000 \times .15 = 750$). Option B has less rentable square footage and thus would cost less per month for the same amount of usable space!

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With the same rental rate, the tenant would pay more per month on his lease for Option A at 6,000 rentable square feet. However, one factor to consider is with higher load factors, are you getting better shared amenities that justify the cost? In some cases, a fancier lobby and shared kitchen area could be enough of a draw to justify the higher cost for the same amount of usable square footage.

As shown above, rentable square feet is not always so simple. To make matters worse, sometimes landlords will even fudge the load factor and USF numbers to the point where it becomes part of the negotiation process itself. As with all commercial real estate leases, always read the fine print so you understand exactly what you're paying for and exactly what you're getting in return.

Common Lease Components

Term of the Lease

This defines the specific timeframe the tenant has the legal right to occupy the space, including the lease start and lease end date.

Rent

This is the amount of rent the tenant is obligated to pay the landlord under the lease agreement. Rent is commonly quotes on an annual per rentable square foot basis but can also be quoted in other ways such as monthly, total annual amount, etc.

Escalations

This defines if and when rent will be increased over the term of the lease.

Typically leases will have annual escalations tied to an inflation index such as CPI

(the consumer price index). However, escalations can be defined in many different ways, including on a dollar per square foot basis, an annual percentage amount, an annual dollar amount, etc.

Renewal Options

Lease renewal options give the tenant the right but not the obligation to renew their lease. The renewal period is typically pre-specified in the original lease. For example, a lease could have a single 5-year renewal option at the expiration of the original lease. The rent and other terms of the lease could be pre-specified as well, however, this is often set based on the then prevailing market conditions.

Expense Reimbursements

This describes which building expenses will be “passed through” and paid by the tenant and also defines how much and when these payments will occur.

Common Area Maintenance (CAM)

This is a specific expense reimbursement or pass-through for all costs related to maintaining common areas in the building. Common areas include lobbies, elevators, hallways, parking lots, etc. Typically this is calculated based off of the percentage of rentable square feet the tenant occupies.

Expense Stop

This is the level (or maximum amount) up to which the landlord will pay certain operating expenses. Amounts above the expense stop are the tenant’s responsibility. An expense stop is a tool used by landlords to limit their exposure to operating costs, and as such helps to maintain predictable operating expenses over the term of a lease.

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Let's run through a quick example of how expense stops work in practice. Let's say we're looking at a 10,000 square foot office building with 2 tenants occupying 5,000 square feet each. Each tenant signs a lease for \$25 per square foot with all expenses passed through to the owner, up to \$7 per square foot or \$70,000 per year.

Suppose operating expenses actually turn out to be \$100,000 per year. That means that the tenants would be required to pay \$30,000 towards operating expenses, while the landlord's out of pocket cost would be limited to \$70,000. Normally in multi-tenant buildings, each tenant is only responsible for their pro-rata share of operating expenses above the expense stop. So, in this case, each tenant would only have an out of pocket obligation of \$15,000.

"Base year" expense stops are also common. With a **base year expense stop** the landlord pays all of the first year operating expenses for a tenant, and then in subsequent years the tenant is responsible for any expenses in excess of the base year amount. The portion of expenses above the expense stop that are passed through to the tenant are commonly referred to as "Recaptured" or "Recovered" expenses.

Percentage Rent

In addition to the common lease components above, sometimes retail tenants will also have what's known as percentage rent. This section will explain how percentage rent and breakpoints work, with clear examples along the way.

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Simply put, percentage rent is extra rent paid based on a percentage of gross sales. Percentage rent situations can be found in certain commercial spaces such as shopping malls and other multi-tenant retail spaces. The idea behind percentage rent is the shopping center is a natural draw for customers, who will tend to walk among the various shops. The owner also creates an advantage for all of the retailers by selecting what businesses are placed in the same space, e.g. having a coffee shop, dry cleaners, restaurant, and a general store all being neighbours. This advantage and ability to attract customers can enable the owner to negotiate a percentage of sales.

How Percentage Rent Works

Commercial leases with a percentage rent provision will have a minimum rent paid, which is just a basic rent provision typically based on a dollar amount per square foot of space. For example, a retailer may pay \$10 per square foot with 4,500 sqft, and thus would pay \$45,000 in rent or \$3,750 per month.

The percentage rent would kick in after a certain amount of gross sales are met. The point at which percentage rent is paid is called a “breakpoint” and can either be a natural or artificial breakpoint. If the breakpoint is never met, the tenant is only obligated to pay the minimum rent.

An artificial breakpoint is simply a dollar amount of sales both parties agree on. For example, a landlord might negotiate that 5% of gross sales over \$800,000 should be paid in percentage rent. If the gross sales are \$1,000,000, then the renter pays 5% of \$200,000, or \$10,000 in extra rent.

To calculate the natural breakpoint, which is commonly used as well, you simply divide the base rent by the established percentage. In the above example, that

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would mean dividing \$45,000 by 5%, which equals \$900,000 in gross sales as the natural breakpoint. The logic behind the natural breakpoint is that a retailer should only pay the percentage rent on sales over and above what is required to pay the minimum rent. In other words, taking 5% of \$900,000 in sales would equal the minimum rent payment of \$45,000, so it makes sense that the percentage rent requirement would only kick in after this minimum rent breakpoint is achieved.

As you can imagine, the minimum rent amount and percentage rent can be negotiated. In some cases, a retailer may wish to have a higher minimum rent with a higher breakpoint, which allows them to profit at lower sales levels before percentage rent comes into effect. This could be the case for businesses that recently opened and are just launching their marketing.

When evaluating percentage rent situations, retailers should be aware of what types of revenue are included and excluded, as in most cases returned items and employee sales are not counted towards the total. Owners will also require tenants to allow audits of gross sales, require regular sales reports, not allow tenants to close shop during certain stretches, and ask that retailers not open additional locations within the same market area.

Percentage rent is a fairly straightforward concept, but can sometimes get tricky when it comes to breakpoints, inclusions and exclusions. As with all commercial real estate leases, the devil is in the details and as such leases should always be read thoroughly.

Conclusion

In this short eBook we discussed commercial real estate leases at a high level by describing the spectrum of all CRE leases. We then went over how to calculate usable versus rentable square footage, and finally we detailed several common components of commercial real estate leases and walked through step by step examples along the way.

