Chapter 1
THE IMPORTANCE OF A GREAT LEASE

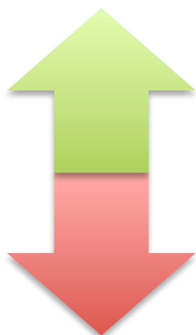
'The lease, and only the lease, drives value'

Here is the most unrecognized fact that impacts everything about leasing. Investors in a retail property don't actually buy the real estate. That is not their primary focus. Instead they are buying the existing and potential cash flow and profit from the leases. And the leases are secured by the covenants of the tenants. The better the lease and the more stable the tenant to be able to fulfill the lease terms, the better the value.

In the acquisition due diligence process considerable time, energy and effort are spent verifying the quality of the leases and the income. The potential purchaser looks at the quality of the income, the covenants of the tenants and the quality of the lease documents. They use any diminishment from the ideal to discount the income and the purchase price. At the same time, the potential purchaser is looking at opportunities to capitalize on improvements to the leasing they can make.

They also look at the risks associated with the real estate itself. They ask themselves questions such as the need for capital expenses, deferred maintenance, ongoing cost of operation, etc.

As you can see, the leases represent the investment opportunity but the real estate represents the risks to that opportunity.



Opportunity from Leasing

Risk Associated with the Real Estate

Anyone who mostly focuses on the real estate itself misses a significant opportunity to increase returns and value by improving the quality of the leasing negotiating process and documentation. That bears repeating:

Anyone (other than the facilities management professionals, whose job is to efficiently manage the physical real estate asset) who spends the majority of their time, attention and efforts on the physical real estate – the building and the lands - and not on improving the quality of the lease transaction and lease management is not adding value or improving returns.

Improving the leasing process adds more incremental value to the owner than cost savings, because there is always more potential upside to improving income than can be found in cost savings.

To illustrate the point, consider that only so much can be saved through cost reduction. Eventually, in an ideal situation, the property would have no costs associated with it. Reality suggests that will never be the case.

Conversely, improving income has no limit.

How $1.00 Equals $20.00

It is vitally important in the highly leveraged business of commercial real estate to understand the impact of a dollar gained or lost in a lease transaction. Commercial real estate is sold and purchased based on the percentage yield the net operating income provides in comparison to the purchase price. As a result, $1.00 can have a significant affect on the value of the asset, all other items remaining equal.

To understand how this occurs, we use the IRV formula. This method converts the income of a property into an estimate of its value. The basic formula is:

Net operating income (I) ÷ capitalization rate (R) = value (V)

Where:

The **net operating income** (NOI) is all revenues less operating expenses exclusive of debt servicing, income taxes, and other non-operating expenses.

The **capitalization rate** (also called the CAP Rate) is the yield of the income based upon a 100% cash purchase price. Stated differently, it is

the annual return produced by the net operating income (NOI). Therefore it is expressed as a percentage.

And the **value** is the purchase price.

Because the NOI is divided by the CAP Rate, there is an inverse and compounding effect on value, as shown in the table below, that shows the value of $1 at various CAP Rates.

THE VALUE OF $1 AT VARIOUS CAP RATES*

CAP RATE	VALUE IMPACT
4%	$25.00
5%	$20.00
6%	$16.67
7%	$14.29

*Cap Rates can also be in decimal increments. IE: 6.35%

Therefore, every dollar gained or lost has a significant affect on value.

Here is a practical example in action. Let's assume that the property was recently appraised using a CAP Rate of 6%, and the landlord increased the net operating income from a 1,500 sf premise through good negotiation by $2.50 per square foot per annum (psfpa).

($2.50 X 1,500) ÷ 6% = $62,500.00

The annual NOI increased by $3,750, but the value of the asset has increased by $62,500 on just that one transaction. Conversely, missing the opportunity to increase the NOI by $2.50 psfpa cost the landlord $62,500 in value that could be added to a sale price, added to a refinancing package, etc.

There are only two variables in the IRV formula. The NOI and the CAP Rate.

The CAP rate is determined by a number of factors, most of which the landlord has little control over; such as market conditions, returns from other investment vehicles, etc. It is true however, that a property with an assurance of the NOI will have a lower CAP rate than a property that is more speculative. While the landlord can't control the general market or the economy, they can control their own business actions, quality of the leases they create, etc.

On the other hand, the landlord has far more control over their NOI. Most of that control is achieved through the quality of the leasing, the negotiating and the lease document.

What Makes a Good Lease?

There are two aspects to a good lease. The first is the structure of the lease transaction, or the DNA of the Deal. The second is the quality of the documentation of that transaction.

Many people believe that a good negotiation produces a win/win outcome. While desirable, this is rarely the case. It is because the lease negotiation is more than just the basic financial terms such as rent, length of lease, etc. The balance of the transaction is all about the transfer of risk from one party to the other.

The landlord wants to transfer as much business risk to the tenant as possible, while the tenant wants to transfer its risk to the landlord. Whichever party in the transaction has the negotiating power will transfer the most risk. Some of the most negotiated clauses in a lease have their roots in this concept of risk transfer. For example, the landlord will want to negotiate a reasonable lease term that allows it to finance the property effectively while reserving the opportunity to improve its future financial position. On the other hand, the tenant

wants to give itself the most flexibility in reserving its location AND ending the lease if it deems that is in its best interest. The end result may be that the landlord obtains term, but the tenant has certain termination rights to end the lease early.

A successful lease transaction is one where both parties believe they can accept the level of business risk they have each agreed to in the negotiation. The negotiation will conclude only when both the landlord and tenant have reached that point.

In the next chapter we will discuss the art and science of lease negotiations in greater detail. You will learn how to retain as much negotiating strength as possible and to minimize the risk transference from the tenant to the landlord. After all, it is the landlord who has the greatest investment in the real estate and each transaction.

Another, but less recognized, aspect of the concept of risk transfer is in the quality of the documentation.

A well-negotiated and documented lease is a thing of beauty. It almost goes without saying that the final lease should be concise and written in clear language that leaves little room for misunderstanding. Unfortunately, that isn't always the case, as you will see in the chapter about 'trap door' clauses.

An old joke aptly notes the flaw in a poorly worded lease clause and the implications it can have. It is from a vintage Saturday Night Live skit performed in 1984 and it demonstrates how ambiguous language can be. It goes something like this:

They were the parting words of a nuclear engineer turning over a new, sophisticated power plant to the two people who would operate the plant after he left. He said; "The most important thing to remember is that you can never put too much water into this nuclear cooling chamber."

Within an hour of his departure an alarm in the cooling chamber sounded. One operator said to the other; "Remember you can never put too much water into this cooling chamber, so lets add water."

"No", said the other operator, "He said you can never put too much water into this cooling chamber. There must be too much in the system, so lets take some water out."

Thus ensued a heated argument about what to do next until the entire system failed, with no one taking action for fear it was not what was

meant with the instruction: “The most important thing to remember is that you can never put too much water into this nuclear cooling chamber.”

The two parties negotiating the lease and those committing the understanding of the negotiation to paper should also remember that during the term other people will have to interpret the intent of the agreement between the two parties.

Poorly negotiated and worded leases increase administrative costs for both the landlord and the tenant. It can lead to account collection problems and poor tenant relations. In the worst case scenarios, it can lead to protracted and expensive legal battles and a significant loss of reputation.

On the other hand, a well-crafted lease should be more than concise and clear, and note the business terms. It should also reflect how the landlord intends to run the property during the term of the lease. It should clearly set expectations and set out the respective obligations on both the landlord and the tenant. For this reason, the landlord should not rely on an ‘off the shelf’ template lease to meet their needs.

While a landlord ‘standard’ lease form can serve as the basis for all the landlord’s properties, the basic lease form should be modified for the way each property operates.

It is just as inappropriate to use a lease intended for a large, enclosed shopping centre for a grocery anchored open air centre as it is the other way around.

Although many of the property specific matters can be captured in the rules and regulations schedule to the lease or the construction schedule, the entire lease needs to be reviewed with the landlord’s objectives for the investment in mind.

Here is a simple example why the lease needs to be tailored to how the property will be operated.

Does the landlord want the tenant to maintain the heating, ventilation and air conditioning system (commonly known as the HVAC system), or will the landlord maintain it at the tenant’s cost? Will that landlord-completed maintenance be under a bulk contract covering all the HVAC units at the property, or even over several properties (meaning the landlord may need a basis for apportionment of the costs between properties detailed in the lease), or on an individual store basis?

Conversely, if it has been left to the tenant to maintain, what type of maintenance does the landlord require, how frequent will it be and how will the landlord know the tenant is maintaining the HVAC system?

Then there are the questions of who conducts repairs and replacements beyond regular maintenance of the HVAC system and which party pays for them?

All these questions should be answered in the lease. And you can see that the concept of the transfer of risk is inherent in these questions and answers. As a result, while HVAC is not a major risk point in the overall lease, the question of who is responsible, and the costs associated with the HVAC system will need to be negotiated as part of the overall negotiation. A lease that doesn't specifically address how the property will be operated will lead to confusion, misunderstanding and the types of issues a good lease is meant to resolve.

Here is a real life example: A landlord in Greater Los Angeles with a multi-tenant office building wanted to save legal costs and used a 'fill-in the blank' type of lease form intended for a single tenant industrial building. Because the lease was for a different asset class it didn't accurately describe the property, what costs should be borne by the tenants and how those costs should be allocated. Because the lease was generic, it didn't account for the particular requirements of the site.

The end results were confusion over the costs, how the property was to operate and each tenant's role in their interactions with other tenants and the landlord as well as lost revenue opportunities, rent collection issues, tenant dissatisfaction, increased management costs and a loss of value and return to the landlord.

A one time saving of a few thousand dollars cost the landlord years of expensive problems.

IN SUMMARY

Investors are more interested in the NOI than the bricks and dirt of real estate.

A change in the net operating income has a compounding affect on the property value. Mistakes are very costly and can carry on for years.

A significant portion of the lease negotiation is about risk transfer between the parties.

A good lease has both a good structure and is well written in clear, concise terms.

Off the shelf leases must be modified to address the operation of the property and how the parties are meant to interact during the term.