Appendix 1: A Primer on Commercial Leases

Commercial properties are sometimes owner-occupied, but are usually purchased for their income-producing capacity. Income for these properties is normally secured by a lease contract. The appraiser's most important "first" step is to analyze and interpret the leases, to determine how certain elements impact on value. Thus, it is important to be familiar with lease documents, and be able to read one correctly to determine the relevant information and how it affects the income stream and risk level of a property. Furthermore, it is important to be able to identify and separate the various interests that may exist in a leased property.

The income-producing nature of these properties has a significant impact on all steps of the appraisal process. Leases provide crucial data for both the subject property and for comparable properties. This appendix provides an overview of the components of a typical commercial lease, the various types of tenancies governing the landlord/tenant relationship, the special terminology appropriate to income-producing properties, and an overview of special use leases.

Leases Defined

A lease can be defined as "a contract transferring the right to possession and enjoyment of real estate for a definite period of time". Because the landlord and tenant relationship creates rights and duties for both parties, it is important that these rights and duties be incorporated into a document that is acceptable to both parties to help prevent any argument or confrontation that could ultimately arise. It is these lease documents which govern the relationship between the tenants and the landlord, and hence the income stream of the property. The wording of the lease determines not only the rent being paid, but also when it is paid, who pays for operating costs and taxes, what is permitted on the premises, and so on.

There are certain common denominators that occur in all leases regardless of the length of the term. Whether a lease term is for a week, a month, a year, or more, clauses dealing with payment of rent and expenses, repairs, and permitted uses will always appear. Beyond the scope of these basic clauses, there will also be a variety of other clauses to accommodate the specific building type and its uses.

Essential Elements of a Lease

In order for a lease document to be considered a binding agreement, it must contain several essential elements, including as a minimum:

- the names of the parties to the lease;
- the demise, or letting, of the premises;
- the description of the property;
- the commencement date;
- the duration of the term;
- the amount of rent and method of payment;
- the signatures and acknowledgments of the parties to the lease; and
- the covenants and conditions under which the tenant holds occupancy.

The first elements are usually quite brief and can usually be incorporated on a single page. It is the covenants and conditions which can be extensive. The type of property, its use, and the detailed covenants and conditions will, of necessity, take up many pages as it covers the rights and duties of both parties.

Leases are normally drafted by the landlord and, as a result, there is a tendency for the covenants and conditions to be written in favour of the landlord. The exception to this is leases for government departments which are often subject to a standard government lease format.

Gross and Net Leases

Leases for premises in buildings are usually set up as either a *gross* lease or a *net* lease. This definition relates to what rental amount is paid by the tenant to the landlord and what this rent includes. First consider the objectives that both landlord and tenant have when negotiating the terms of a lease. One key consideration is to minimize operating expense payments
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Consider for a moment some typical expenses which are incurred in the operation of a building: non-structural repairs; structural repairs; heating, ventilation and air conditioning (HVAC); building maintenance; landscape maintenance; janitorial services; security; utilities; electricity and gas; insurance; property taxes; and management.

During lease negotiations, a tenant may be faced with two extreme alternatives: pay a total rent which includes all expenses; or, pay a base rent, plus applicable expenses.

From a tenant's point of view, the rent which includes all expenses is the best, because then it is the landlord's responsibility to pay any increases in expenses until such time as there is a rent review or there is an adjustment for any escalation in expenses. This is a "**gross lease**", (sometimes also called an "inclusive lease").

At the other end of the scale, the tenant pays a base rent plus all the applicable expenses, including any increases which occur from time to time. This is generally referred to as a "**net lease**". The most common is the "**triple net lease**" where the tenant is responsible for all property expenses, with the exception of management and structural maintenance and repair. In an "absolute net lease", the tenant is responsible for all expenses, including management and structural maintenance; and the rent is total profit to the landlord.

A lease is the result of negotiation and hence appraisers must carefully determine exactly what is paid by the tenant and what by the landlord. The appraisal report should define the nature of the lease in detail, and identify who is responsible for what expense. This is critical to ensure that the subject's lease and all comparable leases are analyzed on an identical basis in applying the valuation methods.

Gross and Net Leases

Gross Lease - tenant pays rent and property owner pays expenses.
Modified Gross (Semi-Gross) Lease - tenant and property owner share expenses.
Single Net Lease - tenant pays rent, utilities, and taxes or insurance; property owner pays structural repairs, property maintenance, and property taxes or insurance.
Double Net Lease - tenant pays rent, utilities, taxes, and insurance; property owner pays structural repairs and property maintenance.
Triple Net Lease - tenant pays rent, utilities, taxes, insurance, and maintenance; property owner pays structural repairs only.
Absolute Net Lease - tenant pays rent and all expenses.

In practice, a landlord is normally responsible for the cost of repairs to foundations, structural walls, and to the roof of most buildings. The exception is sometimes a very basic warehouse where the lease provides for all repairs to be performed by the tenant. However, the operating expenses and taxes are negotiable. If a tenant pays some but not all the operating expenses and taxes, the lease is known as a **partially net** or **partially gross** lease. It is up to the appraiser to determine the total rent recovered from a property (basic rent plus operating expenses and taxes), through review of the rent roll, income statements, and, if necessary, the leases.

Although gross leases are less common today than triple net leases, they are still negotiated, especially by government tenants and by tenants in older buildings that have low rental potential. Such leases, however, usually contain **escalation clauses**. An escalation clause is a provision to allow the landlord the right to recover rising operating expenses. Without an escalation clause, the landlord's rental profit could be eroded.

> **Example: Escalation Clause**
> Consider a lease set at \$100.00 per m^2 (\$9.29 per sq.ft.) gross, with operating costs and taxes equivalent to \$46.18 per m^2 (\$4.29 per sq.ft.). This leaves \$53.82 per m^2 (\$5.00 per sq.ft.) in "net" rent for the landlord.
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> If taxes doubled in the following year, a gross lease would leave this increase in costs to be borne entirely by the landlord, reducing the landlord's income as well as the value of the property.
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> If instead the lease was originally worded to include the initial year as the **base year**, with any increases in expenses over the base year to be paid by the tenant, then the tenant would be responsible for the doubling in taxes, so that the landlord would still receive a net equivalent rent of \$53.82 per m^2 (\$5.00 per sq.ft.). This escalation clause protects the landlord's position, preserving the net income stream of the building and the value under the income approach.

To summarize the discussion on gross and net leases, there are basically five types of leases:

- a pure gross lease;
- a gross lease with escalations over a base year;
- a partially net or partially gross lease (where the apportionment of operating expenses between landlord and tenant can be identified by reading the lease document or receiving detailed breakdowns from the property manager or landlord);
- a triple net lease where the tenant pays a base rent plus all operating expenses, including property taxes, but excluding structural repairs and perhaps management; and
- an absolute net lease where the tenant pays a base rent plus all costs associated with the real property.

Lease Documents

Leases are subject to considerable variation in both length and format. Property managers, landlords, tenants, and lawyers all have their own particular concept of how to prepare the perfect lease. Opinion varies on what matters should be covered by the terms and conditions. Even when the intent is the same, no two people will use the same wording. Until you have had extensive experience in reviewing, negotiating, and administering leases, you should have someone with expertise review a lease with you. This is especially the case when there is a legal matter which relates directly to one or more clauses in a lease document. For such matters, it is also advisable to consult legal counsel for interpretation of a particular clause as to its intent and any legal ramifications.

List of Typical Clauses Found in Standard Leases

The lease document is the source of key data required for the income approach analysis. The following list provides the clauses found in many typical lease documents. However, this list is by no means all-encompassing, as a lease may contain all or fewer of the provisions.

- date of the lease
- reference information, if the lease is registered
- legal description or other identification of the leased premises
- name of lessor - owner or landlord

- name of lessee - tenant
- lease term - commencement date, termination date
- occupancy date
- rental amount, including any percentage rent, graduation or escalation provisions, rent concessions, and terms of payment
- landlord's covenants - lessor's responsibilities for items such as taxes, insurance, maintenance, utilities, etc.
- lessee's responsibilities - for items such as taxes, insurance, maintenance, utilities, etc.
- right to assign or sublet - can the lessee assign or sublet, and on what terms and conditions
- use of premises (purpose and use) clause - states for what type of business the premises may be used
- option(s) to renew - what rights does the lessee have and what are the obligations
- option to purchase
- escape clauses
- security deposits, including advance rent, bond, or hold by the lessor on the lessee's improvements
- casualty or damage clause - what happens in the event of damage or destruction to the lessee's obligations to continue in occupancy and pay rent
- lessee's improvements - what is the nature of the lessee's improvements and what happens to them at the termination of the lease
- expropriation clause - what reference is made to the rights and obligations of the lessor and lessee in the event all or a portion of the premises are expropriated
- revaluation clause - what provision is made in the event of revaluation for rental purposes
- arbitration clause - what provision is made for the resolution of disputes between the landlord and tenant
- special provisions
- restrictions
- signature page

Registration of Leases

Registration of interests in land is under provincial jurisdiction and varies from province to province. In most provinces, leases can be registered on title to protect a tenant’s interest. Registration provides assurance to the tenant that persons in future who wish to do business with respect to the leased property, such as purchasers or lenders, are aware of the existing leases. The protection for the tenant is in the form of priority of title. For example, a lease made before a mortgage will have priority on title and, in the case of foreclosure proceedings, the mortgagee cannot get possession of the rented premises until the lease expires. The tenant may continue to pay rent to the landlord until the mortgagee becomes entitled to possession and gives notice to the tenant.

In British Columbia, leases with terms of less than three years (five years in some other provinces) do not need to be registered to be recognized by the courts. Longer term leases must be registered for them to be enforceable regarding future owners of the real estate, yet very few leases are registered on title. This begs the question, why aren’t all leases registered? There are a number of reasons, the most important of which is that registration is only beneficial to the tenant.

Landlords, on the other hand, prefer not to have lease registered. First, while it is relatively simple to register the lease, it is cumbersome to have it removed from title upon expiry or upon the tenant vacating. A tenant’s signature is required to release the charge from title, yet if the tenant has left, they may have little interest in their former premises. This is especially true if the tenant left prior to expiry or with arrears. Second, landlords prefer leases not to be registered as the information within those leases then becomes public knowledge. Anyone can search title to a property, including the assessment agency, competing real estate owners (who may benefit from knowing the exact terms of the lease, especially the rental rate and the expiry so that they can entice a tenant to their building), and potential tenants (who may use this information as a bargaining tool). To some extent, the amount of information that is publicly available can be minimized by registering a short form of a lease which contains at minimum only the parties to the lease, the premises, commencement date, and term.

Third, the process is more management intensive and costly, in part for the first reason mentioned above, but also because of the time involved to register and meet other requirements such as having a "registerable plan" form part of the lease. For a lease to be registerable, it must include a registerable plan which outlines the leasable area and the building area, including a site plan. These can only be prepared by an approved land surveyor, which again requires additional costs to be incurred.

Thus, while it is advantageous for tenants to have leases registered, typically standard landlord leases will not permit this. It then becomes an item to be negotiated, with a shrewd landlord (or property manager) requesting concessions for such a clause to be included. Typically, only the more sophisticated tenants or those with long-term commitments will push for this clause. Examples are financial institutions or larger national tenants whose terms are often well over ten years with options to renew. Tenants who have highly improved premises or for whom moving costs would be particularly onerous may also push for such a clause.

> The fact that few leases are registered in the Registry or Land Titles Office means that these important sources of information and data verification are not available to the appraiser.

Lease Analysis

The list below summarizes important provisions to be aware of when analysing a lease. For a more detailed review of leases and lease analysis, readers may wish to refer to *CPD 109: Lease Analysis*.

Assignment and Subletting - this is a very important clause in the determination of the lessee's interest in the property. The provisions of this clause must be clearly understood and no careless assumptions should be made by the appraiser that a lessee automatically has an interest if the market rent exceeds the contract rent.

Operating Expenses - the financial position of the landlord is dependent upon what share of the operating expenses (often defined as "Additional Rent") will be absorbed by the lessee. Read this clause carefully to determine what share the lessee will pay, how it is calculated, and what items are included and excluded.

Options to Purchase - leases may contain a "right of first refusal" to purchase the property if the lessor receives a bona fide offer from a third party. This does not prevent the lessor from selling the property, but merely gives the lessee the right of first refusal to buy it. Generally, the lessee will have a limited time, e.g., three to five business days to exercise its right of first refusal. A clause which gives the lessee a definite option to purchase the property, especially if the price is set in the lease, should be given considerable weight. The relationship of the actual market value of the property to the option must be accounted for in the appraisal.

Options to Renew - the rights of the lessee to renew the lease are important and the terms and conditions (including rental) should be clearly understood. This section of the lease often has a "not less than clause" included, that the market rent upon renewal will not be less than the rent paid in the year prior to the renewal.

Rent - what is the rent, how is it paid, and are there any rent free periods or concessions.

Restrictive Clauses - any restrictions on either the lessor or the lessee should be noted and understood.

Term - the length of the term is very important. You must find out how much time is left and what rights the lessee has at the end of the term.

Type of Lease - is the lease a net or gross lease. Don't accept the lessor's statement that it is a triple net lease; no matter whether the lease is described as net or gross specifically ask to see the actual terms (or get written documentation to keep on file) so you can satisfy yourself who is responsible for what.

Use of Premises - specifies what the premises can be used for by the lessee.

Lease Terminology

There are many types of leases in the marketplace and the terminology used to describe them is often used incorrectly or in a misleading way. A careless interpretation can lead to a faulty estimate of value. It is important to take nothing for granted in reviewing and analyzing the structure of leases, even if the property appears to be simple and straightforward. The following are the most commonly used terms in the real estate industry with regards to leases. It is important to understand the intent of the terms when gathering and analyzing data relevant to the valuation of commercial properties.

Lease: A lease is a written document or contract conveying or transferring the right to the possession and enjoyment of real estate for a specified period of time in return for a specified rent.

Lessee: The tenant or one who possesses the right of use of the property of another. Also called the leaseholder.

Lessor: One who conveys by lease, the right of use of the property to another. Usually the holder of the fee interest or owner (landlord).

<u>**Lease Types**</u>

Flat Rental Lease: A flat rental lease specifies a level of rent that continues throughout the duration of the lease. This type of lease is typical and acceptable in a stable economy. However, in a changing economy, leases that are more responsive to the changing market conditions are preferred. Flat rental leases used in inflationary periods tend to be short term.

Graduated Rental Lease: A graduated rental lease provides for specified changes in the rent at one or more points during the lease term. A **step-up lease** can allow for lower rent payments in the early years and can be advantageous to a tenant establishing a business. This type of lease can also be used to recognize tenant expenditures on a property that are effectively amortized during the early years of the lease. It is also used by landlords who want to bring existing tenants up to market rents upon renewal, over a period of time. Long term ground leases may include provisions for increasing rent to reflect the expected increase in the market value of a property and protect the position of the lessor.

Step-down leases are less common than step-up leases and are generally used to reflect unusual circumstances particular to a property such as the likelihood of reduced tenant appeal in the future or the recognition of capital recapture of interior improvements during the early years of a long-term lease.

Gross Lease: The gross lease is the opposite of a net lease. It is a lease in which the owner or lessor pays taxes, insurance, maintenance, services, operating costs, etc. The gross lease today is largely confined to residential apartments and older and/or smaller office buildings. When it is used for commercial properties, it often includes escalation clauses which at least partially protect the lessor from rising expenses.

Index Leases: An index lease is usually a long term lease and provides for periodic adjustments based on a change in a specific index such as the Consumer Price Index (CPI).

Net Lease: A lease where, in addition to the rental stipulated, the lessee assumes payment of all property charges, such as taxes, insurance, assessments, maintenance, etc. In some instances the lease may be described as "triple net". However, the terms generally mean the same as a "net" lease but the question should always be asked "Who pays for what?" This is the most common type of lease used in commercial properties.

Percentage Lease: A lease wherein the tenant (usually retail tenant) is required to pay a specified percentage of gross or net sales made upon the premises. Sometimes it is combined with a base rent, e.g., the greater of $12,000 per annum or 12% of gross sales in excess of $100,000. There are many variations of percentage leases.

Revaluation Leases: A revaluation lease provides for periodic rent adjustments based on revaluation of the real estate at then current market rates. Revaluation leases tend to be long-term but some short-term leases contain renewal options with rents to be negotiated or arbitrated based on then market value of the property. The rights of both parties to use arbitration processes is common in the event the market rent applicable cannot be agreed upon.

<u>Definitions of Rent</u>

Annual Effective Rate: The annual effective rate of a lease is the face rate of a lease, adjusted to stabilize the impact of any tenant inducements over the term certain of the lease to indicate the annual rental rate equivalent that reflects the same level of rent over the term certain of the lease. Term certain ignores any options to renew or extend the lease. The annual effective rate of the lease is often expressed as dollars per square foot or square metre.

Contract Rent: Contract rent is the actual rental income specified in a lease.

Excess Rent: Excess rent is the amount by which contract rent exceeds market rent at the date of the appraisal

Face Rate: The face rate of a lease is the unadjusted, stated rate of rent, often expressed as dollars per square foot or square metre, as contained in the lease.

Inducements: Inducements are offers made by the landlord to entice a tenant to enter into a lease agreement. Lease inducements can include: periods of free rent; cash allowances; or, free (or reduced cost of) tenant improvements such as carpeting, painting, wiring

Market Rent: Market rent is the rent that a property would most probably command in the open market given reasonable exposure. It is indicated by the rents paid as per the recently signed "arms length" leases. Market rent is sometimes referred to as economic rent.

Overage Rent: Overage rent is the percentage rent paid over and above guaranteed minimum rent. It is not to be confused with Excess Rent. Overage Rent is a contract rent and it may be market rent, part market and part excess or excess rent only.

Rent & Rental: The consideration paid by the lessee for the possession or use of the property.

<u>Specific Lease Terms and Conditions</u>

Covenants: Clauses in a lease that delineate the rights and obligations of the lessor and lessee.

Escalator Clause: A lease covenant providing for the tenant to pay any increase in taxes and or operating expenses above a base year, usually that prevailing at the time of execution of the lease or as otherwise specified in the lease. Tax and expense stop clauses are more often added to traditional gross or flat rental leases to protect the lessor from escalating costs. Clauses of this nature provide that all increases of in operating expenses become the obligation of the lessee. The increased expenses are usually prorated among the tenants in proportion to the space occupied.

Escape Clause: Escape clauses permit the lessor and/or lessee to cancel a lease due to specific circumstances such as expropriation of the property or damage which renders the lessor incapable of restoring it within a reasonable period of time.

Landlord Improvements: A detailed list of the work to be performed by the lessor at the lessor's expense to the leased premises, often as an inducement to the tenant to enter into the lease. In some instances the lessee may negotiate a lower rent at the beginning in return for completing all or a portion of the lessor's work.

Purchase Option: A lease covenant granting the lessee an option to purchase the leased property. The manner in which the option may be exercised varies from lease to lease. It may be at the termination of the lease or at specified dates during the lease. The price may be established when the lease is signed or it may be based on market value at the time the option is exercised or some other formula specified in the lease. A purchase option can restrict the marketability of a property. The option clause may represent a limit on market value of the leased fee estate

Renewal Option: A lease covenant giving the lessee the right to extend for an additional period of years on specified terms or terms to be agreed upon. Renewal options are binding on the lessor, but allow the lessee, a tenant, to reach a decision at the time of renewal based on the circumstances prevailing at that time. They are generally considered favourable to the lessee, not the lessor, as it restricts the lessor's future options with respect to what can be done with the building. It does, however, create stability which is usually desirable for both parties.

Right of Refusal: A lease covenant that gives the lessee the right to purchase the property in the event the lessor receives a bona fide offer from a third party. This type of clause does not restrict the marketability of the property but can delay the lessor's acceptance of the offer depending on the timeframe the lessee has to exercise its "right of first refusal".

Tenant Improvements: A detailed list of the work to be performed by the lessee or at the lessee's expense. It is imperative to check to see if the rent reflects the amortized cost of the improvements if carried out on behalf of the lessee by the lessor.

Types of Tenancies

Tenancy at Will - There is no contract for a tenancy at will. The circumstances under which such an arrangement are made usually involve a relative or a friend. There is no agreement and no payment of rent or charges of any sort; the occupancy may be terminated at any time at the option of the landlord. Such a tenancy should not be considered by an appraiser as evidence of market activity, rather premises leased in this nature will usually have a market rent applied, with comments made in the report with respect to this.

Periodic Tenancy - Any occupancy or tenancy that is automatically renewed on the last day of the term for a further term of the same length is referred to as a "periodic tenancy". It is periodic because the occupancy runs from period to period (week to week or month to month) and continues until such time as either party gives notice. A periodic tenancy is normally terminated by one period's notice, although longer periods may have different notice requirements.

Any periodic tenancies in a building should be carefully examined by the appraiser, due to their lack of a fixed term. If the tenant has been in the premises for some time and the rent is reflective of market rates, then the rent can be applied in the appraisal analysis, with appropriate comments relating to the periodic nature of the tenancy. If, on the other hand, the rent is above or below market rents, the premises should be assumed to be entered at market rents for market valuation purposes.

Fixed Term or Term Certain - The expression "term certain" is used to describe the time frame for a leasehold interest whose duration runs for "a definite period of time". Fixed term lease documents will state the duration or term of the lease in years, followed by a commencement date. The majority of premises in commercial buildings are leased on this basis. More detail is provided later in the lesson.

Tenancy at Sufferance - Upon expiry of the term of a lease, if the tenant does not move out, it is then said that the tenant "holds over". When this occurs, a "tenancy at sufferance" is created. In effect, a tenancy at sufferance occurs when there is no tenancy because no lease exists. For appraisal purposes, if there is a tenancy at sufferance in a building being valued, the appraiser must determine (through conversations with the landlord, property manager and/or the tenant) whether the tenant will renew, and if so, at what rent. Any assumptions relating to such premises should be clearly stated in the appraisal report. In anticipation of a "hold over" occurring, most commercial leases contain a clause dealing with this issue. This clause could reads as follows:

> …in the event that the Tenant should hold over, the tenancy shall be construed as one of a month to month and the minimum rent payable shall be two times the minimum rent provided for in the last preceding year of this Lease.

In that case, the landlord can terminate the lease by giving one month's notice, provided the lease does not contain any contrary notice provisions. The rent as per this clause is two times the previous rent and is probably <u>not</u> indicative of a "market rent" for appraisal purposes.

Month-to-Month Tenancy - A lease agreement (perhaps by implication) cancellable by either party - usually upon 30 day (or 1 month's) notice, but it can be longer - but subject to Provincial Statutes.