

CHAPTER 4

Leases

Prior to exploring the different types of commercial properties that REITs own, it is instructive to understand the different types of leases that REITs, as landlords, use. A lease is a legal agreement between a landlord (the *lessor*, which is the REIT) and a tenant (the *lessee*) whereby the tenant agrees to pay rent for a defined period of time in exchange for the right to occupy the landlord's space. Most leases require monthly payments of rent, but other intervals—for example, as annual payments—can also exist. It depends on the terms agreed to between the landlord and tenant. The terms of the lease discussed in this chapter are negotiated between the landlord and tenant and spelled out in the lease agreement.

Along with the length of each lease, which is usually expressed in months or years, different lease structures translate into different cash flow streams to a landlord. Tenants and landlords negotiate all aspects of a lease, including the length of time a property will be leased (*lease length, term, or duration*), who will pay for which operating expenses, and who will pay for improvements to the tenant's space. Each type of lease allocates different costs to the landlord or tenant and determines which person bears the risk of paying higher costs if utility or other expenses increase. Lease length and structure, therefore, are fundamental predictors of REIT stock price performance, which is discussed at length in Chapter 7. The content of this chapter provides an overview of the four major types of leases, including which structures are most commonly used among different property types.

Lease Terminology

Most people are familiar with the concept of paying rent, but many are not aware of the different types of rent they will pay under different scenarios. An asking rent of \$15 per square foot listed on a building's "for rent" sign means something very different under a gross lease than under a full-service lease, both of which are addressed on the following pages. Before discussing the four basic types of leases, it is helpful to become familiar with some basic terminology:

- **Base year** is the 12 months of a lease or the period that ends with the first full calendar year of a lease. In the latter instance, the base year will be more than 12 months. It is often used to set the expense stop (defined below) in a full-service or modified gross lease.
- **Common area maintenance (CAM)** are charges the landlord incurs to maintain areas of a multi-tenanted property (which simply is a building that has more than one tenant) that are accessible to all tenants, such as the landlord's property management fee, labor costs associated with the building's engineering team, lobbies, shared restrooms, and a parking area. In a multi-building office park or campus, CAM fees can also include costs associated with a fitness center or foodservice area that are accessible by tenants throughout the campus. CAM fees are in addition to a tenant's base rent, and the landlord typically bills tenants according to the percentage of the building they rent. For example, if a tenant's space represents one-third of the building's rentable square footage, then that tenant would be billed for one-third of the CAM associated with the building's upkeep.
- **Escalation clauses**, or escalators, are set future increases in rent that the tenant agrees to pay during the course of a lease. Escalations can be expressed in dollar amounts or as a percent and typically occur on an annual basis. Rent escalations tend to be tied to increases in the Consumer Price Index (CPI) or expressed as fixed periodic increases. As an example, a tenant may agree to pay a monthly base rent of \$1,000 in year 1, and then an additional \$100 per month each subsequent year for the duration of the lease. In year 5, therefore, the tenant's

monthly rent would have escalated to \$1,400 (Year 1 = \$1,000; Year 2 = \$1,100; Year 3 = \$1,200; Year 4 = \$1,300; Year 5 = \$1,400).

- **Expense stops** are most common in full-service and modified gross leases. The landlord will bear the operating expenses and CAM associated with the tenant's space up to the expense stop amount; the tenant will bear any expense overage. For example, operating expenses and CAM on Tenant A's space in Year 1 are \$4.50 per square foot, so the expense stop is set for the duration of the lease at that level. For the remainder of the lease, the landlord will use \$4.50 of the base rent received to pay the tenant's operating expenses, and will bill the tenant for any amounts that exceed this expense stop.
 - **Capped expenses** are similar to expense stops and, in some areas of the country, are referred to as expense stops. However, instead of being a fixed dollar amount, expense stops are a maximum percentage increase in expenses.
- **Leasing commissions (LCs)** are paid to real estate brokers who represent the tenant and/or landlord. (Tenants' brokers are often referred to as *tenant reps.*) Typically the brokers are paid 50 percent of their LC upon lease execution and 50 percent upon lease commencement. The LC generally is calculated as 2 to 8 percent of the total rent payable for the initial term of the lease. So if a tenant will pay a landlord total annual rent of \$10,000 for three years, and the leasing commission rate in that market is 4 percent, then the landlord will need to pay the leasing agent \$1,200 ($\$10,000 \times 3 \text{ years} \times 4 \text{ percent}$). If there is a broker representing the landlord, then an additional LC would be owed following a similar schedule.
- **Operating expenses** are costs associated with operating and maintaining the rented area of a building. Such costs include real estate taxes, property insurance, utilities, and janitorial services for tenant-specific areas (as opposed to common areas shared with other tenants). Operating expenses do not include capital expenditures for structural maintenance of the building, and they do not include interest payments on any mortgage associated with the property being leased. Each lease specifically identifies what can and cannot be included as part of the operating expenses.

- **Rent**—There are different types of rental revenue a landlord can receive. Table 4.1 summarizes the different types of rent, including escalations (as described in the preceding text):
 - **Total, base, gross, or contract rent** are all ways of describing the amount of money a tenant will have to pay the landlord each period, as defined in the lease. It includes agreed-upon expense stops and reflects any rent escalations that have become effective.

Table 4.1 Comparison of Different Types of Rent

Assumptions					
• 15,000-square-foot rentable area	• 3% annual escalations on base rent				
• 5-year lease term	• 4% leasing commission				
• \$25.00 base rent per square foot	• 4 months of rent (after concessions)				
• \$4.50 expense stop & CAM	• TI allowance of \$15 per square foot				
	Year 1	Year 2	Year 3	Year 4	Year 5
Total rent per square foot	\$25.00	\$25.00	\$25.75	\$26.52	\$27.32
+ Escalation	—	\$0.75	\$0.77	\$0.80	\$0.82
New total rent per square foot	\$25.00	\$25.75	\$26.52	\$27.32	\$28.14
× Rentable square feet	15,000	15,000	15,000	15,000	15,000
Total rent	\$375,000	\$386,250	\$397,838	\$409,773	\$422,066
– Expense stop ^a	–67,500	–67,500	–67,500	–67,500	–67,500
Net rent before concessions	307,500	318,750	330,338	342,273	354,566
– 4 months of free base rent	–125,000				
Effective rent landlord realizes	182,500	318,750	330,338	342,273	354,566
Less:					
Tenant improvement allowance ^b	–225,000				
Leasing commission ^c	–61,137				
Net effective rent received by landlord	–\$103,637	\$318,750	\$330,338	\$342,273	\$354,566
Aggregate net effective rent received	\$1,242,289				
Net effective rent per square foot ^d	\$16.56				

^aExpense stop and CAM is calculated as \$4.50 × 15,000 rentable square feet.

^bTI is calculated by multiplying the \$15 TI allowance times the rentable square feet, or \$15 × 15,000.

^cLC is calculated by adding the “Effective rent landlord realizes” in all five years, times 4%.

^dThe net effective rent per square foot equals the “Aggregate net effective rent received,” divided by the rentable square feet, divided by the lease term (\$1,242,289 ÷ 15,000 SF ÷ 5 years).

- **Net rent** is the amount of rent a landlord retains each period, after paying (or *net of*) expenses associated with property operations and maintenance.
- **Effective rent** is net rent, adjusted to reflect the cost of any concessions and leasing commissions the landlord has agreed to as part of the lease agreement. The most common concessions are tenant improvements and free rent, both of which are discussed later in this chapter.
- **Free rent** is a period of time (usually a few months but sometimes up to one year) during which time a landlord grants the tenant occupancy rights to the rental space without requiring contract rent be paid. Free rent is a concession a landlord is willing to pay to entice a tenant to lease a space.
- **Market rent** is the rental rate associated with comparable spaces in similar buildings and locations.
- **Square feet**—There also are different ways of measuring the same building, depending on the information needed:
 - **Gross square feet (or gross building area)** measures a building's total constructed area to the outside of its walls. Gross square feet generally is not used for leasing purposes unless the tenant leases the entire building, in which case the gross square feet equals the rentable square feet.
 - **Rentable square feet** is the sum measurement of a tenant's useable area, plus that tenant's pro rata share of the building's common areas.
 - **Useable square feet (or useable area)** measures the amount of space that can be used by tenants within the walls defining the space they have rented. Note that if a building is leased entirely to a single tenant, then rentable square feet equals useable square feet.
- **Tenant improvement (TI) allowance** is an amount of money the landlord is willing to spend on a space to retain an existing

To summarize square footage measurements:

- Multi-tenanted building: Gross > Rentable > Useable
- Single-tenant building: Gross = Rentable = Useable

tenant or entice a new tenant to lease a space. Note that TIs paid by a landlord that improve the future leaseability of a space—such as lobby and bathroom improvements—are depreciated on a different schedule than the building itself. Tenant improvements typically are depreciated over a 7-year life, versus a 15-year life for leasehold improvements, and 40 years for the base building.

- **TIs for first-generation space**—When space is newly constructed, the landlord typically budgets for a higher TI allowance because the tenant will need to build out space from a shell (also referred to as *unimproved*) condition. Because of the greater expense associated with building out new space, tenants that lease first-generation space typically sign longer-term leases of five or more years. Tenants often exceed the landlord’s TI allowance and invest additional money into their space. The more a tenant invests its own money into rental space, the more likely that tenant is to renew the lease at the end of the lease term.
- **TIs for second-generation space**—When a space has been occupied previously, it is called second-generation space. The TI dollars a landlord pays to retain the existing tenant tend to be for cosmetic improvements, such as new carpet and painting walls. If the lease length being negotiated is long enough or if the landlord is trying to re-tenant the space with a new tenant (perhaps one with better credit), then TIs are likely to be higher and include some modest structural improvements, such as updating the tenant’s bathroom(s).

The Four Major Types of Leases

There are four broadly defined types of lease agreements: gross, net, modified gross, and full service. The name of each lease structure is *not* universal in nature; each region of the country tends to have its own nomenclature and lease standards. Putting precise terminology aside, any lease that results from landlord–tenant negotiations reflects risks and rewards that both parties agree upon and are willing to bear. Table 4.2 summarizes the major types of leases, including a simplified example of the different payments made by a tenant to

Table 4.2 Comparison of Major Lease Types

	Gross	Net*	Modified Gross	Full Service
Contractual rent per square foot paid to landlord	\$15.00	\$15.00	\$19.00	\$23.00
– Base year expense stop and CAM [†]	n/a	n/a	–4.00	–8.00
Net rent to landlord	15.00	15.00	15.00	15.00
+ Reimbursement for expense overage [‡]	n/a	n/a	2.00	2.00
Total rent per square foot paid to landlord	\$15.00	\$15.00	\$17.00	\$17.00
Risk of cost increase borne by:	Landlord	Tenant	Tenant [†]	Tenant [‡]
<u>Who pays what:</u>				
• Nonstructural repair and maintenance	Landlord	Tenant	**	Tenant
• Operating expenses (utilities, janitorial, etc.)	Landlord	Tenant	**	Tenant
• Property taxes	Landlord	Tenant	**	Tenant
• Insurance	Landlord	Tenant	**	Tenant
• CAM	Landlord	Tenant	**	Tenant
Property type(s) most associated with this lease structure:	Lower-priced, lower-quality properties	Retail Industrial Single-tenant	Industrial Office	Office

*Example illustrates a triple-net lease.

[†]With a base-year expense stop, the tenant reimburses the landlord for any cost overruns. The only risk the landlord bears is during the first (or base) year of the lease: if actual expenses per square foot end up being higher than the amount forecasted in lease negotiations, then the landlord will have to absorb the cost difference. Also, if the lease is a full-service lease without a base-year expense stop, the landlord would have to absorb any increases in cost.

[‡]To the extent operating and CAM costs exceed established expense stops, the tenant will need to reimburse the landlord.

**Depends on the terms of the lease. Generally in a modified gross lease, the tenant pays taxes and insurance.

the landlord according to the general terms associated with each type of lease, which are described as follows:

1. **Gross lease**—a lease in which the tenant pays the landlord a fixed monthly rent and the landlord assumes responsibility for paying all operating expenses, taxes, and insurance

associated with the property. If costs rise, the landlord absorbs them, which is another way of saying a gross lease shifts all the risks onto the landlord during the term of the lease. The tenant's rent does not change. Unsurprisingly, the gross lease is rarely (if ever) used, and often only for short periods of time and at lower-quality properties.

2. **Net lease**—a lease in which the tenant pays the landlord a fixed monthly rent and is also responsible for paying all or some of the expenses associated with operating, maintaining, and using the property. There are three levels of “net” that express which expenses the tenant pays in addition to rent:
 - Maintenance, which includes items like utilities, water, janitorial, trash collection, and landscaping
 - Taxes
 - Insurance

A net lease generally implies the tenant pays rent and property taxes. In a double-net lease the tenant pays rent, property taxes, and insurance; the landlord bears the other costs (though often with an expense stop). A double-net lease more often is referred to as a “modified gross” or “gross industrial” lease, which is described in the following paragraph. In a triple-net lease, in addition to the monthly rent, the tenant pays all costs associated with property operations, maintenance, insurance, and taxes. The landlord essentially collects monthly “coupon” payments from the tenant, similar to receiving monthly interest income from having invested in a bond.

Triple-net leases are used most often by landlords leasing a freestanding building to a single tenant, where that tenant wants the operating flexibility associated with the triple-net structure. Examples of the types of buildings REITs own that generally are leased using the triple-net structure include fast-food restaurants, industrial warehouses, health-care facilities, or office buildings that serve as corporate headquarters.

3. **Modified gross lease**—a lease that is similar to the double-net lease described in the preceding discussion on net leases. Often called a gross industrial lease, the modified gross lease is one in which the tenant pays the rent plus the property taxes and insurance, and any increases in these items over

the base year. The landlord pays the operating expenses and sometimes the maintenance associated with the property. In the case in which a landlord uses modified gross leases and has multiple tenants in one building, the landlord will charge the tenants a CAM fee. As described at the beginning of this chapter, CAM charges are additional rent charged for maintenance that benefits all tenants, such as snow removal and outdoor lighting. Tenants generally will be charged a dollar amount representing their proportionate share of expenses, based on the square feet they lease. Modified gross leases most often are used with multi-tenant office buildings, industrial properties, and retail properties.

- 4. Full-service lease**—a lease in which the tenant pays the landlord a fixed monthly rent that includes an expense stop calculated off the base year. The landlord pays all the monthly expenses associated with operating the property, including utilities, water, taxes, janitorial, trash collection and landscaping and charges the tenant in subsequent years to the extent operating expenses exceed the expense stop. The tenant gets full service in exchange for the monthly rent and does not have to contract with service providers directly. Full-service leases most often are associated with office buildings.

Leases and Tenant Bankruptcy

In the event that a REIT's tenant goes into bankruptcy, that tenant still has to pay the rent due under its lease(s) with the REIT. This is because the leases are viewed by bankruptcy courts as operating expenses, which have a senior claim over that of creditors or investors on the cash flows of the company reorganizing under bankruptcy laws.

Fact: Leases between a REIT and a tenant are viewed by bankruptcy courts as operating expenses, which are senior to the bankrupt tenant's debt obligations to lenders. Accordingly, a tenant must continue to pay rent to their landlord (the REIT), even while going through bankruptcy.

The tenant must continue to pay the REIT its contractual rent until the bankruptcy court judge allows the tenant to “reject” the lease. The fact that leases are legal, senior claims on the cash flows of tenants is a major reason that REITs do not necessarily go bankrupt, even when some of their tenants do. Please see Chapter 3, REIT Dividends, for further discussion of this concept.

FASB and the New Standard for Accounting for Leases

In February 2016, the Financial Accounting Standards Board (FASB) issued significant and final changes to the accounting treatment of operating leases (described earlier in this chapter). FASB is the organization that establishes standards of financial accounting for U.S. companies, and the SEC recognizes those standards as being appropriate. Historically, tenants did not capitalize operating leases on their balance sheets and, instead, treated rent payments as expenses that were accounted for in their income statements. The biggest change introduced by FASB’s new standard, which goes into effect for REITs on January 1, 2019, will cause tenants to create an asset, which is their right of use on leased space, and a matching liability on their balance sheets equal to the present value of lease payments agreed to in their leases. The anticipated change to the REIT industry is that tenants may prefer to use shorter duration, triple-net leases in order to minimize the liability they will begin showing on their balance sheets. Although the bottom-line economics to REITs should not change, companies will need to adjust their reporting outputs and leasing processes, accordingly.

Lease Duration and REIT Stock Price Performance

On a fundamental level, a REIT’s cash flow is the sum of all cash received from tenant leases less any overhead costs for paying management and employees, and the financing costs of any debt the REIT may have outstanding. Property fundamentals, meaning the supply of and demand for real estate, differ widely among the various types of commercial properties and ultimately are the largest governors of REIT returns. However, the length and structure of a lease also dictate how stable (or volatile) a landlord’s cash flows are over time. Understanding the type of lease a REIT uses with tenants will help predict how its common shares will trade during different economic scenarios.

Knowing the average lease length and the type of lease structure a REIT uses helps predict how its shares may trade during times of economic expansion and contraction.

Chapter 7 discusses the relationship between lease length and stock price performance in more detail, but it is worth highlighting here, as well. Shorter leases translate into more volatile future earnings and, by extension, wider daily swings in price for those REITs' shares. In contrast, longer leases generate steady income that is similar to receiving interest payment from a bond. This consistent income stream tends to translate into stock-price movements that reflect the underlying stability in rents. Both extremes—short-term and long-term lease durations—have their respective opportunities and risks.