A Reprint from *Tierra Grande*, the Real Estate Center Journal

Commercial Leases
Key Clauses and What They Mean

By Wayne E. Etter and Rafael Figueroa

A property's estimated net operating income (NOI) is one basis for estimating its value. Because a property's estimated NOI depends on the payments expected from individual tenants, real estate analysts should review the economic clauses that are part of each commercial property lease. From the lease-by-lease review of the economic clauses, an analyst assembles the following information used to estimate the annual NOI for the analysis period.

- Expiration date of current leases
- Current rental rate and rental growth rate
- Proportion of operating expense paid by the tenant

Commercial Property Leases

Although commercial property lease forms are standardized, there is no such thing as a standard commercial property lease. The negotiation between landlord and tenant usually results in some addition to, subtraction from or a wording change in the standard form before the parties reach agreement.

When a strong landlord and a national tenant negotiate a commercial property lease, both parties rely on previous negotiations; both are likely to have advice from experienced legal advisors. But in some cases, the parties may not be evenly matched. For example, a strong landlord may be negotiating with an inexperienced local tenant, or an inexperienced landlord may be negotiating with a strong national tenant. And if both parties are inexperienced, the outcome may be unpredictable. Thus, the specific terms of commercial property leases may vary significantly, even among tenants in the same property. To correctly forecast the property's income stream, therefore, it is essential to analyze particular clauses in each tenant's lease. Because the property's estimated value is based on its estimated income, analyzing each lease is essential to the valuation process.

Lease Commencement Date

Forecasting the property's income stream begins with determining the remaining term of each lease. A lease is dated when it is negotiated and signed; however, the lease may begin on a later date. For example, if a lease is signed before construction is completed, there may be considerable time between the date the lease is signed and the date the property is ready for occupancy.

Correctly identifying the lease commencement date is important because the lease's expiration date depends on the commencement date rather than the signing date. The information contained in the lease agreement's economic clauses assists in estimating a particular tenant's contribution to NOI as long as the lease is in force.

The lease expiration dates also indicate periods when vacancies may occur. The analyst must consider the probability that the current tenant will renew the lease or that a replacement tenant can be obtained if the lease is not renewed.

Minimum Rent

The agreed fixed minimum rent is stated in the lease, usually in terms of the monthly rent to be paid. The per-square-foot rental rate is calculated by dividing the fixed minimum annual rent by the number of square feet leased.

Long-term leases may have a means to enable the property's owner to cope with rising management costs and to achieve a competitive rate of return. Specific increases in the monthly fixed minimum rent may be agreed to when the lease is negotiated; although these planned increases are included in the lease, they may be noted in an entirely different section of the lease from the statement of the initial fixed minimum rent.

Future increases in the fixed minimum rent also may depend on changes in a specific economic indicator such as the Consumer Price Index. Linking rent increases to specific economic indicators may be used alone or in combination with specifically stated increases in the fixed minimum rent.

When future rental increases are not specifically stated, forecasting future rental income is more difficult for the analyst because the future course of inflation must be estimated. Nevertheless, making such an estimate may be easier than forecasting future market rental rates, which depend on the supply and demand for a particular type of space in a specific market area.

Projecting the minimum rent for a fully leased property for the period of analysis is relatively simple; however, future rent may be more or less than what would be received if the property were rented at market rent levels.

Percentage Rent

Lease agreements between retail tenants and retail center owners usually include a fixed minimum rent and a percentage rent provision. This provision

requires the tenant to pay the larger of the fixed minimum rent or a stated percentage of gross sales. For example, if the fixed minimum rent is $5,000 per month ($60,000 per year) and the percentage rent is 5 percent of gross sales, the tenant will pay $60,000 per year until the store's gross sales exceed $1,200,000 (.05 × $1,200,000 = $60,000). Gross sales of $1,200,000 are called break-even sales. The percentage of gross sales used to calculate the percentage rent may vary for different levels of gross sales in excess of break-even sales.

The break-even sales amount usually increases each year. The annual increase should at least be equal to expected inflation. In this way, the tenant is protected from paying a higher rent resulting from sales increases caused by price inflation rather than the increased quantities of goods.

Percentage rent allows the owner to share in the benefit of rising sales over time and encourages the owner to maximize the center's appeal to consumers. If there were no increase in the fixed base minimum rent or if the tenant's rent increased without concern for increased sales (for example, a lease that specifies the periodic amount of increased rent or a lease that links rent increases to changes in an index), the retail center's owner might be less concerned with the center's competitive position. But with rental increases linked to the store's sales, the retail center's owner has an incentive to maximize the center's attractiveness for consumers. Thus, this provision ought to be an advantage for both the tenant and the landlord.

When the lease contains a percentage rent provision, the determination of a tenant's gross sales revenue must be carefully defined. The tenant usually will be required to provide audited financial statements. Also, the lease may provide that if the tenant opens another store within a specified distance of the subject center, that store's sales will be included in the determination of rental income.

Percentage rent clauses present the analyst with a forecasting problem—will gross sales increase? If so, what will be the rate of increase? Will it be more or less than the rate of inflation? Will future competition diminish the tenant's market area and, therefore, the level of gross sales? Although questions such as these are difficult for the analyst to answer, they are important because the assumed outcome will affect the retail center's estimated value.

Operating Expenses

In addition to the required rental payments, lease agreements usually require tenants to pay their *pro rata* share of the property's operating expenses. These additional payments may include the tenant's *pro rata* share of property taxes, property insurance, common area maintenance expenses and utility expenses but not leasing and property management expenses.

The tenant's *pro rata* share normally is calculated as follows:

$$\frac{\text{Area leased}}{\text{Building's gross leasable area}} = \textit{Pro rata} \text{ share}$$

$$\textit{Pro rata} \text{ share} \times \text{total expense} = \text{Tenant's share}$$

The analyst should review the demised premises clause to confirm how the number of square feet included in the area leased (i.e., the demised premises) and the building's gross leasable area are to be measured. Usually, the leased area is measured to the center of partition walls and to the outside of exterior walls with no reduction for interior partitions, stairwells or similar areas. For properties with multiple tenants, the analyst also must determine how the building's gross leasable area is measured; the description of this measurement is usually in this section of the lease.

When tenant pays:	Lease is called:
• No additional payments	Gross lease
• Property taxes and insurance	Double net lease
• Property taxes, insurance and common area maintenance	Triple net lease
• Property taxes, insurance, common area maintenance and utilities	Quadruple net lease

Typically, each of the foregoing expenses is carefully defined in separate sections; these sections usually contain considerable detail, and the analyst must review them carefully.

When all operating expenses are paid by the tenants, the property's estimated NOI is essentially equal to the property's estimated rent collections; for such leases, the property's NOI may be forecast with greater certainty. However, the lease agreement may limit the annual increase in operating expenses that the tenant pays to a specified percentage of the previous year's operating expenses. This is known as an *expense stop*. If actual operating expenses increase by more than the specified percentage, the excess is paid by the owner.

Also, the owner normally bears the *pro rata* share of operating expense for unleased space. For this to be so, however, the tenant's *pro rata* share must be based on the property's **gross leasable area** and not the **gross leased area**.

Thus, the analyst must be concerned with the property's expected operating expenses for the analysis period even though a cursory review may indicate that all operating expenses are to be paid by the tenants. Vacancies and expense stops may require the owner to pay some portion of the operating expenses.

Other Clauses

Some long-term retail leases require tenants to remodel their premises prior to their lease's expiration. Also, most retail center leases require tenants

to spend an amount equal to a specified percentage of gross sales on advertising each year. Such clauses are intended to maintain the center's competitiveness and, therefore, its value.

Use clauses limit the nature of retail tenants' product lines and, therefore, limit competition among tenants within a retail center (e.g., only one tenant is allowed to sell pharmaceuticals). If, however, a weak retailer is losing business to similar retailers in other centers, but a use clause prevents the owner from securing another tenant with the same product line, the center's overall competitiveness and value may suffer.

The economic clauses of commercial property leases may vary among a specific property's tenants. As a result, two tenants occupying equal space may make significantly different payments to the property owner. Because the property's estimated value is based on its estimated income, analyzing each lease is an essential part of the valuation process.

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Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115.

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