FINANCING FOCUS

Knowing the Lease

Understanding who is paying for what can help improve communication between real estate pros and clients.

by Gregory J. Laskody, CCIM

Commercial real estate has a jargon all its own, with plenty of acronyms and abbreviations. But considering such vast differences in geographical markets and industry sectors, meanings can change and differ from, for example, the retail market in South Florida compared to the industrial sector in the Inland Empire area of California.

Developing a definitive, widely accepted dictionary for every term might not be feasible. Let's discuss terms related to commercial real estate lease structures so we can have a clear, concise understanding of the primary concepts.

In basic terms, leases are structured based on property type. But this is also dependent on two things:

1. The market or sub-market that a particular property is located within.
2. Who pays for what expenses, both operating and ownership, associated with a particular property.

The more "gross" a lease is, the more that the operating and ownership expenses become the obligation and responsibility of the landlord; conversely, the more net a lease is, the more that the operating and ownership expenses become the obligation and responsibility of the tenant. Said differently, in a gross lease, a tenant will pay one flat rental rate to the landlord, with the landlord directly paying all operating and ownership expenses associated with the property; in a net lease, the landlord receives a base rent, with the tenant either paying some or all of the operating and ownership expense directly, or reimbursing the landlord for these expenses (such reimbursement has its own terminology, such as operating expense recoveries, pass-throughs, reimbursements, and common area management).

Certain property types will contain rent and lease structures that can vary greatly, even if properties are across the street from one another. For example, a Class A multitenant office building located in a downtown urban core may include entirely all gross leases, while a mixed-use lifestyle and entertainment center located next door may have a net lease structure. Also, similar property types may have different lease structures, based on the characteristics in that given market or sub-market, which are influenced by prevailing market trends. For example, retail leases have generally been structured as net, while office leases have generally been structured as gross. In certain office markets, however, this trend is shifting as landlords and property owners attempt to own and operate buildings, while at the same time transferring as much of the uncontrollable expense risk to their tenants as possible.

The following graphic shows a spectrum of common CRE lease types. One problem: Double-net to one person is modified-gross to a second. Unfortunately, the industry doesn't have one accepted classification of these CRE lease structure types, because they vary from market to market, property type to property type, broker to broker, and source to source. If there isn't a consensus on definitions of specific terms, how, as an industry, can we be crystal clear on who is paying for what in a quoted rental rate?

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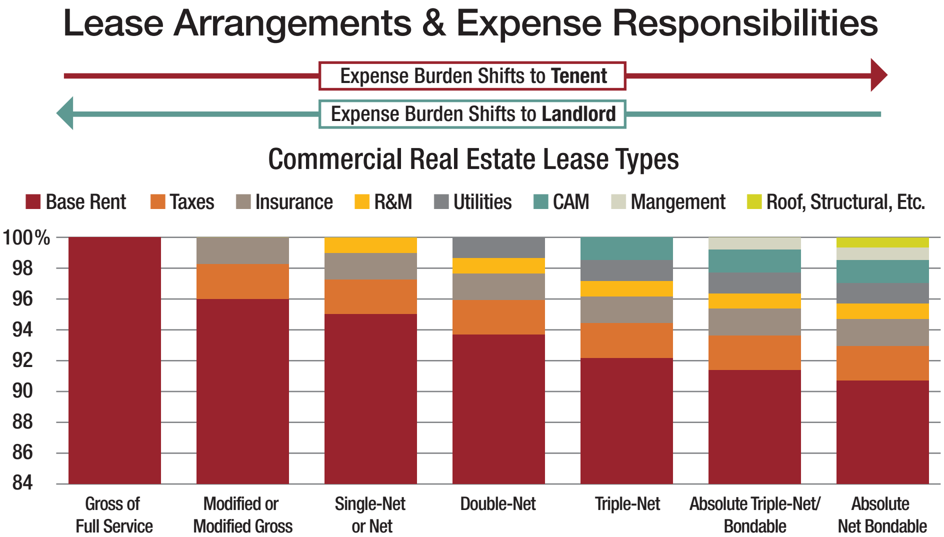
But all involve two simple things:

1. Which operating and ownership expense obligations belong to the landlord/property owner?
2. Which operating and ownership expense obligations belong to the tenant?

Looking at the graphic, it assumes 100 percent of the rent is paid to the landlord by the tenant. If the market is in equilibrium — which always happens, right?! — gross rents will always be equal to the net rents plus all reimbursable operating expense items on a pro-rate basis for each tenant. This graphic shows how, within each lease structure, the burden for operating expense shifts from landlord to tenant.



Source: Lee & Associates South Florida

Here are some CRE lease structures prevalent in the current marketplace, categorized from those with the landlord having most, if not all, of the operating and ownership expenses (capital expenditures), to lease structures that shift more and more operating and ownership expenses to the tenant. Other terms for these lease structures could be in markets located outside of my own, but almost all will fall into these general categories.

Gross or Full-Service: The landlord directly pays all operational and ownership costs associated with the building in a gross lease, including base rent, operating expenses, fixed expenses including property taxes and insurance, and variable expenses including repairs and maintenance, landscaping, trash removal, and utilities. In a gross or full-service lease, the tenant pays one amount to the landlord on a monthly basis that includes all the items detailed above. Landlords with gross leases must absorb all tax and insurance increases, repairs of short- and long-lived items, and capital expenditures over the entire term of the lease.

Modified, Modified Gross, or Industrial Gross: The tenant and the landlord share some or all operating expenses. The landlord institutes an expense stop, which is the level (or maximum amount) up to which the landlord will pay certain operating expenses. Amounts exceeding these limits are the tenant's responsibility. An expense stop is a tool used by landlords to limit exposure to operating costs and maintain predictable operating expenses. A modified structure may also prescribe that a tenant pays its pro rata share of taxes and insurance, with the landlord paying all other expenses.

Single-Net or Net: In additional to base rent, in a single-net lease, the tenant pays some or all the property taxes, insurance, and/or maintenance. "Single" refers to one operating expense item being reimbursed, but this has varied over time and marketplaces.

Double-Net: Generally, a double-net lease means the tenant pays for property taxes and insurance, in addition to the base rent, while the landlord pays for maintenance, utilities, repairs, and capital expenditures. A double-net lease can also be referred to as a modified gross lease.

Triple-Net: A triple-net lease calls for the tenant to assume all expenses of operating a property, including fixed and variable expenses and any common area maintenance that might apply, potentially including HVAC, plumbing, and electric systems. However, the landlord remains responsible for structural repairs, utility lines to the property, and sometimes site improvements, such as parking, landscaping, and site lighting.

Absolute Triple-Net/Bondable: Generally, in this agreement, the landlord has no expense or capital responsibilities. The tenant is responsible for taxes, insurance, common area, and all repairs and maintenance, including the roof and the structure.

Absolute Net Bondable: All operating expenses and capital improvement items for the property, in an absolute net bondable lease, are the tenant's responsibility, including casualty, condemnation, all utility lines, and easements. It is essentially a bond — the property owner doesn't have to worry about anything besides what day the rent check hits the bank account. This lease type is favored by lenders because it can greatly eliminate risk. Many leases are accompanied by a corporate guarantee or a credit enhancement provided by the tenant to further insulate the property owner from any loss.

The important thing to remember — whether securing space as a tenant user; projecting revenue as an owner, asset manager, or property manager; or examining a lease an interested third-party, such as a lender, broker, or appraiser — is to focus on who is paying for what operating expenses and capital items. These obligations, as well as how they change over time, should be adequately addressed in every lease, both for the protection of the landlord and the tenant.

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