OAK INVESTMENT MANAGEMENT GROUP

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Real Estate Leases

Commercial real estate is underpinned by a contract between a landlord and an occupier. These are colloquially called leases. Apart from the physical state of building, leases are the most important pillar of value in commercial real estate. Like any contract, if a lease is clear and robust then it is of more value than if it opaque or has imperfections. A legally imperfect lease can jeopordise the assumed rental cashflows, can narrow the forms of recourse available to a landlord as creditor and consequently can cripple the sale value of a building.

A proper understanding of leases is especially important where there are multiple leases in the same building or when a building is subject to 'decked' leases. Decked leases occur when the original leaseholder has passed on their rights and obligations (usually with the permission of the landlord) to another party in what is called a sublease. Because there can be any number of subleases there can be a veritable 'family tree' of leases which, from the point of view of the ultimate beneficiary of the cashflows or of the legal security on the underlying real estate, is only as strong as the weakest link. Therefore, it is always important for a purchaser to go through, understand and assess the risks of every single lease and sub-lease. This is a test of the legal structure as well as the commercial covenant strength of each promising party to the lease.

From a commercial point of view, the next most important aspect of the lease for an investor is its length. Length dictates how long assured income comes in for, or how quickly (if a redevelopment is planned) the owner can get vacant possession. If there is more than one lease the length is calculated either by weighting the length according to the rental amounts of each lease or to the occupational size of each lease. Each of these measurements leads to (or variants of) the weighted average unexpired lease term (WAULT).

For an investor, an important calculation about a generic lease is optionality for the leaseholder, that is to say, whether the leaseholder has the right to vary or terminate the lease itself. This can range from pre-designated stepped rental uplifts / open market rent reviews to the right to break the lease. Stepped rental uplifts may sound like a good thing for the owner of real estate but are not if they are an unsustainable escalator into the sky: If a stepped rental increase means that the rent coming in on a building is out of synchronisation with a comparable building then it is labelled 'over-rented'. An over-rented building cannot be sold as readily and presents re-investment problems at the end of the lease for the investor. Open market rent reviews sound relatively straightforward but they are an assessed rather than empirical value, as a result, they can be problematic without ready comparables or where transactional market activity is muted.

Leases are a basic building block of commercial real estate. Getting them right is an essential but 'reading' them is also important. Professional real estate evaluation can identify the opportunities as well as the pitfalls of all sorts of leases. As ever, the investor must be diligent in their analysis.

Nicholas Frankopan is Managing Director of Oak Investment Management Group pan-European real estate investment manager. To contact the author please email nfrankopan@oakadvisors.co.uk or learn more about the group at www.oakimg.com.