OAK INVESTMENT MANAGEMENT GROUP

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Rent Free Periods in Real Estate

Rent free periods are inducements to occupiers to pay a headline rent that is higher than the actual rate achieved. Rent free periods (and other incentives) that increase the headline rent need to be examined closely in the due diligence of getting to know and buying a real estate asset.

Rent free periods are most common in the office segment: an occupier may commit to ten years or more in a contract and a landlord may agree to give a year of this for free. This also happens in hospitality and retail where the upfront costs are very high and a tenant might be able to streamline and / or stabilise their cash flow situation by delaying the full cost of the lease in the beginning period. Clearly, the practice of granting rent frees is much more prevalent during recessions as a way of dealing with spare capacity as well as keep the nominal rent high.

Typically a rent free is awarded up front with the tenant not paying any rent at the beginning of the lease. But the rent free period can be taken at certain trigger points in the lease (anniversaries or renewal dates) or it can be back ended i.e. contingent on continuous occupation then a certain period in the future is rent free. From an investment point of view it is important to get an idea of the normalised rate with all of these inducements stripped out completely. At that point it is important to assess whether the rent is correct (in comparison to the rest of the market) and that it is sustainable for the tenant in question (in comparison with their balance sheet and profitability). The normalised – and not the headline – rate is the rate that should be capitalised to get the correct trailing yield for the pricing of an asset.

Should the sale of an asset take place during a rent free period, the price of the asset can adjusted to compensate for the lack of running yield through a simple deduction of monies due from the purchase price. Another mechanism is known whereby the vendor pays a 'top up' rent for the period where there is no rent coming in. This is less tax efficient than the former mechanism as both the sale price and the income are taxed regardless of the circular nature of the transaction. It also exposes a purchaser to continued counter-party risk with the vendor.

Should an asset require repeated and constant rent frees for a tenant to stay or sign a lease this is not a good sign for an investor. It means that the tenant has undue power / influence over the pricing – and ultimately can hold a landlord to ransom over their continued stay in the building. Either the building is not competitive enough in terms of its qualities (in which case it would be a mistake to invest in it) or the tenant is gaming the landlord with the leases that they are signing (in which case it is sometimes necessary to seek a new fully committed tenant). Used in the correct way a rent free period secures the goodwill and the good cash flow of a tenant who seeks to stay for the long term in a building. However, used unscrupulously rent frees can distort the pricing signal and allow a purchaser to fall into a value trap of believing that the asset is worth more than it is. It is important to be on the lookout for which category a rent free period falls.

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