

Figure 20.1 Common Lease Structures

| Type of Lease | Characteristics |
|----------------------------|--|
| Flat rental lease | The tenant pays a flat amount and gets to use the property for a specific time. At the end of the lease, the property reverts back to the landlord. |
| Variable rate lease | The tenant will pay one amount now and usually a higher amount later. This is a common condition of long-term leases in which increases are needed in the later years. Increases are commonly made using a Consumer Price Index (CPI) adjustment factor. |
| Step-up or step-down lease | These leases are scheduled with increases or decreases on certain dates. The rent can increase due to inflation or can be scheduled to go down as the tenant improvement expense is amortized. |
| Lease with annual increase | This type of lease calls for a standard increase in the rental rate each year. Annual increases are often used in leases of apartments and sometimes in commercial property leases but seldom in leases of industrial facilities. |
| Revaluation lease | These leases require the property to be reevaluated (usually at market value) and the value of the property multiplied by a factor to calculate the rental rate. |
| Percentage lease | This type of lease is usually used for retail properties. The tenant pays a flat amount each year plus a percentage of the sales or a percentage of the sales from the first dollar on. |

Figure 20.2 Common Rent Types

| Type of Rent | Characteristics |
|---------------------|--|
| Market rent | The amount of money the property would command under current market conditions. Market rent can be different from contract rent because this is the amount the property would command ignoring the leases. |
| Contract rent | The amount stipulated in the lease. For leased properties, this represents the potential gross income. This makes some appraisal assignments easier because the difficulty of estimating the rental income is less relevant. |
| Effective rent | The rent that considers any concessions offered to the tenants to entice them to sign a lease. The contract rent may be much higher than the effective rent if the tenant was given six months free rent. |
| Excess rent | The amount of money paid in a lease contract that exceeds the market rate. This is risky income because a tenant who is paying rent in excess of the market rate may try to break or renegotiate the lease. |
| Deficit rent | The amount of rent when the contract rent is lower than the market. If the deficit is large enough, the landlord may try to get out of the contract. |
| Percentage rent | The rental income paid by the tenant in a retail building that is tied to the level of sales. This type of income is less reliable because in a slow economic period the income may decrease substantially. Many appraisers treat this income differently because it is not guaranteed. |
| Overage rent | The rent paid for the percentage rent over the base rent, i.e., the amount of money that represents the percentage of sales. Percentage leases encourage the owner of the retail center to spend money to promote the business of the tenants because it is in the lessor's best interest for sales to stay above the base amount. |

Table 20.1 Reconstructed Operating Statement

| | | |
|---|-------------------------|--------------------|
| Potential gross income (PGI) | 25,000 sq. ft. @ \$9.00 | \$225,000 |
| Vacancy and collection loss | 5% | <u>- 11,250</u> |
| Effective gross income (EGI) | | \$213,750 |
| Estimated annual expenses | | |
| Property taxes | \$33,000 | |
| Property insurance | \$4,500 | |
| Repairs | \$30,000 | |
| Maintenance | \$12,500 | |
| Utilities | \$22,000 | |
| Reserve for new roof covering (\$25,000 @ 1/20) | \$1,250 | |
| Reserve for parking lot resurface (\$12,000 @ 1/15) | <u>\$800</u> | |
| Total expenses | \$104,050 | <u>- \$104,050</u> |
| Net operating income | | <u>\$109,700</u> |

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Table 20.2 Capitalization Rate Extraction Worksheet

| | Subject | Sale 1 | Sale 2 | Sale 3 |
|---------------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
| Reported sale price | | \$1,985,000 | \$1,458,000 | \$3,258,000 |
| <i>PGI</i> for next year | \$510,000 | \$369,000 | \$253,680 | \$601,000 |
| Vacancy and collection loss | – \$25,500 | – \$25,830 | – \$15,221 | – \$48,080 |
| <i>EGI</i> for next year | <u>\$484,500</u> | <u>\$343,170</u> | <u>\$238,459</u> | <u>\$552,920</u> |
| Operating expense for next year | | | | |
| Taxes | \$56,000 | \$44,258 | \$26,000 | \$72,000 |
| Insurance | \$10,600 | \$9,600 | \$4,500 | \$14,500 |
| Management (5%) | \$24,225 | \$17,159 | \$11,923 | \$27,646 |
| Maintenance—building | \$22,050 | \$16,055 | \$10,700 | \$26,500 |
| Maintenance—grounds | \$11,000 | \$8,000 | \$4,900 | \$13,800 |
| Utilities | \$67,000 | \$55,000 | \$34,000 | \$76,800 |
| Reserve fund—roof covering | \$5,000 | \$4,200 | \$2,600 | \$4,200 |
| Reserve fund—parking lot | \$4,500 | \$3,900 | \$2,500 | \$7,500 |
| Reserve fund—HVAC | \$3,200 | \$2,500 | \$2,900 | \$6,200 |
| Reserve fund—elevator | \$1,500 | \$1,200 | \$1,800 | \$3,600 |
| Tenant improvements | <u>\$5,500</u> | <u>\$4,400</u> | <u>\$3,500</u> | <u>\$12,600</u> |
| Total expenses | <u>\$210,575</u> | <u>\$166,272</u> | <u>\$105,323</u> | <u>\$265,346</u> |
| Net operating income | <u>\$273,925</u> | <u>\$176,899</u> | <u>\$133,136</u> | <u>\$287,574</u> |
| Extracted capitalization rates | | 8.9% | 9.1% | 8.8% |

Table 20.3 Cash Flow Projection

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | |
|-----------------------------|---|------------------|------------------|------------------|--------------------|--------------|
| Tenant 1 | \$72,000 | \$72,000 | \$72,000 | \$84,000 | \$84,000 | |
| Tenant 2 | \$66,144 | \$66,144 | \$66,144 | \$66,144 | \$66,144 | |
| Tenant 3 | \$51,600 | \$53,000 | \$60,000 | \$60,000 | \$60,000 | |
| Tenant 4 | \$14,400 | \$18,000 | \$19,200 | \$19,200 | \$19,200 | |
| Tenant 5 | \$27,780 | \$27,780 | \$27,780 | \$27,780 | \$27,780 | |
| Tenant 6 | \$28,800 | \$24,000 | \$33,600 | \$33,600 | \$33,600 | |
| Potential gross income | <u>\$260,724</u> | <u>\$260,924</u> | <u>\$278,724</u> | <u>\$290,724</u> | <u>\$290,724</u> | |
| Vacancy and collection (4%) | – \$10,429 | – \$10,437 | – \$11,149 | – \$11,629 | – \$11,629 | |
| Effective gross income | <u>\$250,295</u> | <u>\$250,487</u> | <u>\$267,575</u> | <u>\$279,095</u> | <u>\$279,095</u> | |
| All expenses | – \$55,000 | – \$56,650 | – \$58,350 | – \$60,100 | – \$61,903 | |
| Net operating income | <u>\$195,295</u> | <u>\$193,837</u> | <u>\$209,225</u> | <u>\$218,995</u> | <u>\$217,192</u> | |
| Reversion (10%) | Last year's income divided by the capitalization rate | | | | \$2,158,366 | |
| Cash flow | \$195,295 | \$193,837 | \$209,225 | \$218,995 | \$2,375,558 | |
| Discounted at 9% | × 91.74% | × 84.17% | × 77.22% | × 70.84% | × 64.99% | Total |
| Present values | <u>\$179,164</u> | <u>\$163,153</u> | <u>\$161,564</u> | <u>\$155,136</u> | <u>\$1,543,875</u> | \$2,202,891 |