Table of Contents

Overview ........................................................................................................................................ vii
Seminar Schedule ......................................................................................................................... xi

SECTION 1

Part 1. Categories of Leases and Rent Structures

Preview Part 1 ................................................................................................................................. 1
Introduction ...................................................................................................................................... 3
Categorizing Types of Leases ................................................................................................. 7
Rent Structures ....................................................................................................................... 10
Appraiser's Role in a Revaluation Lease ........................................................................ 13
Issues in a Percentage Lease ................................................................................................. 14
Review Part 1 ................................................................................................................................ 19

Part 2. Lease Provisions Affecting Rent

Preview Part 2 ................................................................................................................................ 21
Key Terms ...................................................................................................................................... 23
Rent Versus Income .................................................................................................................. 23
Reimbursements/Reimbursable Expenses ............................................................................ 24
Proper Accounting for Expense Reimbursements (CAM) Charges .................................. 26
Additional (Other) Income ........................................................................................................ 28
Proper Accounting Period for Measurement and Recognition of Rent/Income .................. 30
Effective Rent ........................................................................................................................... 32
Making a Property Rights Adjustment .................................................................................... 32
Tenant Improvements .............................................................................................................. 34
Review Part 2 ................................................................................................................................ 35

Part 3. Lease Provisions Affecting Vacancy

Preview Part 3 ................................................................................................................................ 37
Vacancy Terms ............................................................................................................................ 39
Vacancy Related Issues to Consider ........................................................................................ 39
The Impact of Vacancy on the Expense Reimbursement Provision .................................... 44
Valuation Methodology – Vacant Properties or Properties Not Yet Leased to Stabilization ... 46
Review Part 3 ................................................................................................................................ 49
Part 4. Lease Provisions Affecting Expenses

Expense Terms ................................................................. 53
Special Issues Related to Expenses ....................................... 54
Operating Expenses That May Be Addressed in a Lease .......... 62
Expenses/Deductions That May Be Reported by an Owner ...... 63
Online Resources .............................................................. 64
Review Part 4 ................................................................. 65

Part 5. Lease Provisions Affecting Other Terms and Conditions

Lease Terms Relating to Time .................................................. 69
Term of the Lease .............................................................. 69
Clauses Specifying the Leased Area ......................................... 71
Clauses Relating to Tenant Improvements and Leasing Commissions .................................................. 74
Clauses Specifying Tenant Options to Purchase/Lease .......... 75
Use Provisions ..................................................................... 77
Noncompete Clause ............................................................ 78
Provisions Affecting the Expiration of the Lease ..................... 79
Early Termination Clauses .................................................... 80
Review Part 5 ................................................................. 81

SECTION 2

Part 6. Review of Section 1

6.1 Exercise ........................................................................ 85
Review Part 6 ................................................................. 87

Part 7. Introduction to Tenant Credit Risk

What is Meant by Tenant Credit Risk ..................................... 91
Pretest .............................................................................. 92
Current Trends .................................................................. 93
Review Part 7 ................................................................. 97
# Part 8. Identifying Tenant Credit Risk

Preview Part 8 .................................................................................................................. 99
Who is the Tenant .............................................................................................................. 101
Is There a Guarantor of the Tenant (Guarantors) ............................................................. 101
Does Tenant Credit Risk Affect Net Operating Income.................................................... 103
Tenant Credit Risk Judging Factors ................................................................................. 104
Adjustments Used to Reflect Tenant Credit Risk ............................................................... 105
Relationship Between Contract Rent and Market Rent ..................................................... 105
Review Part 8 .................................................................................................................... 109

# Part 9. Evaluating Tenant Credit Risk

Preview Part 9 .................................................................................................................... 111
Credit Versus Noncredit Tenant ....................................................................................... 113
Investment-Grade Tenants ............................................................................................... 115
The Relationship of Tenant Credit Rating and the Capitalization Rate .......................... 123
Recent Trend in Capitalization Rates for Single-Tenant, Credit-Leased Properties ........ 123
Impact of the Economic Cycle ......................................................................................... 125
Review Part 9 .................................................................................................................... 127

# Part 10. Fundamental Credit Analysis

Preview Part 10 ................................................................................................................ 129
Definition of Fundamental Credit Analysis ....................................................................... 131
Publicly Traded Companies ............................................................................................... 131
Nonpublic Companies ...................................................................................................... 132
Basic Fundamental Analysis Using Ratios ....................................................................... 135
Four Cs of Credit Analysis .............................................................................................. 140
Accounting Treatment for Leases .................................................................................... 140
Review Part 10 .................................................................................................................. 141

# APPENDICES

Appendix A ....................................................................................................................... 145
Appendix B ....................................................................................................................... 147
Overview

Seminar Description

_Evaluating Commercial Leases: The Tenant and the Terms Both Matter_ covers two distinct topics that are nonetheless related and are key to the valuation of commercial real estate. The seminar was written for beginner to intermediate appraisers, brokers, lenders, and other market participants who have a variety of background experiences and are directly or indirectly involved in the valuation of commercial real estate.

Section 1 explores the key business features of commercial leases. Participants will see how the key business terms of a lease affect the _quantity_ and _duration_ of the income stream that a property will generate, and specifically, the development of the property’s income statement. The seminar goes beyond merely explaining how the typical business provisions serve as the basis for the appraiser’s estimate of net income and cash flow. Issues that are covered include nontraditional sources of income, the proper period to use in measuring the income, measurement of the real vacancy rate, expenses that might not be recoverable by a landlord if a CAM formula is incorrect, and how other special clauses in a lease can affect the property’s income stream.

Section 2 explores tenant credit risk. Understanding a tenant’s financial strength is key to assessing the _quality_ of the income stream. Even nearly identical properties leased to single tenants with varying credit ratings can have drastically different leased fee values if one tenant has a strong credit rating and the other does not. Long-term leases to a weak tenant can be worthless and may even adversely affect value. This section of the seminar will address issues of how the credit quality of the tenant will impact the quality of the income stream for a property. The class will discuss tenant credit risk, review examples of strong and weak credit risks, and explore various methods of accounting for risk in estimating value. Fundamental credit analysis, which is a topic not familiar to many appraisers, will also be explained. Fundamental appraisal theory, definitions, and problems will provide a variety of real-life scenarios for the class to discuss.

Learning Enhancements

The seminar has been designed with a variety of elements to enhance your learning experience.

- **Preview.** To give you a taste of what is to come, you will find a Preview page that begins each Part. Included on the Preview page is a brief overview of the content, learning objectives to consider as you move through the content, and learning tips that will assist you in understanding the information you’re about to learn.

- **Learning Objectives.** Each learning objective covers essential information you need to know to fully understand the concepts in the seminar. Look them over before the Part begins so that you have a frame of reference while moving through the material. At the end of each Part, read the objectives again. Are you able to do
what is stated? If not, this is the time to ask your instructor for help or to review
the concepts you do not understand.

- **Examples, Discussion Questions, Problems, and Exercises.** Supplementing the
  lectures, we’ve included examples, discussion questions, problems, and exercises
to help you visualize and practice what you’re learning.

- **Fill-in-the-Blanks.** It is proven that when you write something down, you are more
  apt to remember it. The Course Handbook has “missing” content in the outline
  that you will need to add in the space provided in your handbook as the instructor
  reviews the content.

- **Review.** Each Part concludes with a review. Included in the review are the learning
  objectives and key terms and concepts that have been covered.

- **Suggested Solutions.** Answers to all of the exercises, problems, and discussion
  questions are provided behind the Solutions tab at the back of the handbook.

**Classroom Guidelines**

To make the learning environment a positive experience for everyone, please follow these
guidelines:

- 100% attendance is required. No exceptions.

- Limit use of laptops to classroom projects.

- Communicate with business associates during break time instead of class time.

- Put away reading materials such as newspapers and books that are not used in class.

- Silence cell phones.

- Use recording devices only if prior permission has been granted.

- Refrain from ongoing conversations with those seated near you and other
distracting behavior.

**General Information**

- **Calculator.** A financial calculator is required. The accepted model used in the
  seminar is the HP-12C. Other calculators can be used if participants know how to
  operate them. No class time will be used to cover the operation of other calculators.

- **Breaks.** There will be two 10-minute breaks during the morning session and two
  10-minute breaks during the afternoon session. The lunch break is one hour.
- Attendance sheets will be distributed during class to verify attendance during the morning and afternoon sessions.

- Certificates of completion will be e-mailed upon completion of the seminar. Attendance for the entire seminar is required.

**Recommended Texts**


