Buying Commercial Real Estate

Is It Right for You?

McBride
CORPORATE REAL ESTATE

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Introduction

Robert T. Tillsley, SIOR
President

I have been working in the commercial real estate field for over four decades. It turns out, when that happens, you can't help but learn a lot. I also love what I do, and when that happens, you want to share your knowledge with others.

So that's why we are here. I am the President of McBride Corporate Real Estate, a company that has been serving corporate America's real estate needs since 1959. We share a wealth of information about corporate real estate on our website. And we wanted to package some of our best pieces together for you.

I started my career with McBride in 1988, as a Senior Vice President responsible for the marketing of the multi-tenanted office buildings owned by McBride Properties as well as other developers. In 1994, I was appointed President of McBride's National Services Division, where I oversaw customer service, database implementation, maintaining relationships with brokers in the field, and marketing services for the Division. Now as President, I oversee the Paramus, New Jersey, and Central Valley, New York, offices. I am an active member of the Society of Industrial and Office Realtors (SIOR) and the Industrial and Office Real Estate Brokers Association of Metropolitan New York (IOREBA). I have also served as President of CORFAC International, a network of commercial real estate brokerage firms with locations throughout the world. Currently, I am on the Board of Trustees and serve as the Vice Chair at the Bergen New Bridge Medical Center Foundation. And I have had the opportunity to lecture nationally on subjects like lease negotiation and business development and have served on the Board of Governors of the Ramapo College Foundation for more than 30 years.

McBride Enterprises specializes in relationship-based corporate real estate services in the metropolitan New York and New Jersey marketplace, with 70 percent of our business coming from repeat customers. Our clients work with brokers who have an average of more than 20 years of experience in NJ and NY commercial realty. We offer a wide range of commercial real estate brokerage and property management services related to office, industrial, and retail space, in addition to investment properties.

Corporate real estate can be complicated. We do our best to unpack it here, but if you have any questions or are looking for more guidance, I would love to connect. Feel free to contact me at tillsleyr@mcbridecorpre.com.

Robert T. Tillsley, SIOR

The Basics

The Difference Between Commercial and Residential Real Estate

It is always a good idea to start with the basics for those who have an interest, but not the experience, in commercial real estate. The first step is to cover commercial vs. residential real estate and discuss the differences between the two, which are much more than the similarities they share. We have highlighted the five key differences between commercial and residential real estate:

1) **Emotional investment** (or lack thereof)
   One fundamental difference between residential and commercial property is the buyer's emotional connection to it. Most residential real estate is purchased or leased with an emotional factor involved, while commercial properties are viewed more for their utilitarian value. A home purchaser may like the way a house is situated on a lot, while a commercial purchaser is more concerned with the number of loading docks, the ceiling height, or the number of trailers that can be parked on the property.

2) **Deal complexity**
   A main difference between commercial and residential real estate is in their respective negotiations and contracts. Commercial real estate transactions are much more complicated than residential ones. If you're selling a house, typically, setting a selling price is fairly simple: you'll use comparable homes that were sold in the area over a period of time to determine a fair price. When selling a commercial building, however, the rental income, length of lease(s) on the building, and operating/maintenance expenses are all factors in determining the selling price. A related issue is the difference between a commercial and residential real estate agent – they have varied experience to handle the distinct complexities.

3) **Length of sale**
   Another divergence between commercial or residential real estate investing is the time the sale takes from start to finish. In the residential market, a buyer can view four or five homes over a weekend, like what they see, and make an offer. In New Jersey, there's a three-day attorney review window for the contract, and most people are already pre-approved for a mortgage before they even start looking at homes – all of which can help make closing happen very quickly. Commercial properties, however, take much longer to close. A purchase and sale agreement can easily be 50 pages long, typically taking a month of negotiation; and due diligence can take as long as six months, in some cases!

4) **Laws concerning tenants**
   An interesting, yet subtle, difference between commercial and residential real estate is how the law views residential versus commercial tenants. Residential tenants have many rights that don't apply to commercial tenants. Most notably, it's much easier to evict a commercial tenant than it is a residential one. The law always leans in favor of the residential tenant; but in a commercial transaction, it is viewed as an agreement between two equals, and what's in the contract or lease is what both parties have negotiated. It's then up to a judge to decide who is right.

5) **Rental structure**
When discussing commercial real estate vs. residential real estate, commercial leases will either be a net lease – where the tenant pays all the expenses of operating a building, including real estate taxes – or a gross lease – where those costs start with a base for the year, and any increases in cost are passed on to the tenant. With most residential leases, all of those items are included. If a drain is clogged, the tenant calls the landlord to get a plumber; they don't fix it themselves.

The differences between residential and commercial real estate are many, and if you plan on investing in commercial properties, you'll need to be prepared to compete against people who do this for a living and who usually specialize in a particular segment of the commercial market. McBride can help with our commercial real estate consulting services.

The Different Types of Commercial Real Estate

There are many types of commercial buildings. Commercial real estate classification can be broken down into eight basic groups:

Office **Flex** **Mixed Use** **Hotel**

Industrial **Retail** **Multifamily** **Land**

Each commercial property classification can be further divided into various subgroups. Here, we're going to focus on the first four of the different types of commercial real estate: office, industrial, flex, and retail.

Office: This can be single or multiple stories and can be occupied by a single tenant or a number of various businesses. Many investors start by purchasing the building they occupy as an investment. Rather than pay rent to a landlord, the occupant buys the property, enabling them to build equity. The different types of commercial real estate office buildings are usually classified as A, B, or C. "A" buildings have more amenities than B or C buildings – things like food service, underground parking, impressive lobbies, health clubs, and conference facilities.

Industrial: This type of commercial property can also be single- or multi-tenanted. The two main commercial property usage types for industrial properties are manufacturing and distribution facilities. There are many factors in determining the worth of an industrial building, such as the height of the ceiling, the number of loading docks, the size of the property (especially for trailer parking), and its proximity to major highways.

Flex: When evaluating the different types of commercial real estate, some consider flex space to be a subgroup of the industrial category, but it really isn't. In a flex building, the ratio of office to industrial square footage is much higher than in an industrial building. Flex spaces are often used to house laboratories or small-part assembly. Often, the building will be fully air conditioned as opposed to an industrial building, where only the office space is usually air conditioned.

Retail: Another type of commercial property is the retail space. This type of commercial space has many more variants than those previously mentioned. The subgroups of commercial real estate for retail use are broken down by size. The smallest, a single tenant store in a downtown or central business district location, includes businesses like nail salons and dry cleaners. A pad site, the next largest, would consist of a free-standing building, usually 3,000 to 5,000 square feet, and be occupied by businesses like banks or fast-food operations.

The next largest type of retail real estate is the local strip center, consisting of a group of non-conflicting retail firms in a building 5,000 to 20,000 square feet. Anchor tenants such as supermarkets occupy space in community shopping centers that are typically in the 150,000- to 300,000-foot range. In addition to a supermarket, the center may include drugstores, restaurants, and national card stores. The two largest types of retail centers are the regional mall and the power center, which could be upwards of 2 million square feet or even larger. A major difference between a regional mall and a power center is that a regional mall would usually have more than one anchor store, and they would be competitors. You may find Macy's, Nordstrom, and Neiman Marcus all in the same regional center. A power center will have a tenant mix like Home Depot, Best Buy, Costco, and restaurants. Another main difference is the product mix: regional malls usually are more clothing-oriented, while the power center has free-standing buildings called outparcels.

Buying

Buying Commercial Real Estate – Is It Right for You?

If you have a business and need a place to operate, you have an important decision to make – buying vs. leasing commercial real estate. There are positive and negative aspects to each option. We will try to help you make an informed decision on buying vs. leasing commercial real estate by discussing the pros and cons of purchasing a commercial building.

When trying to decide whether to buy or lease commercial property, one advantage of owning the building is that you will be able to build equity. If you pay cash rather than financing the acquisition, you won't have to make mortgage payments and will own the building right away. If you take out a mortgage, you pay a smaller amount and finance the balance by making monthly payments to a lending institution.

As the building appreciates and you make payments, you are building equity in the property. You also have the right to depreciate the building whether you have taken out a mortgage or have paid cash for it.

Another thing to keep in mind with buying vs. leasing commercial real estate is tax considerations. If you finance the property, you can deduct the interest payments when filing the company's taxes.

When deciding to buy or rent commercial property, another advantage to buying is the investment and growth potential. If you purchase a building that is larger than you need for the present time, you could rent out the remaining space and earn additional income. This would allow you to have room for expansion in the future, while remaining in the building. By leasing out the additional space, you would receive money to offset the cost of the extra capacity.

Buying Commercial Real Estate

PROS: +

- Build Equity
- Deduct Interest Payments
- Sublease Unused Space
- Full Control of Property

CONS: −

- Large Downpayment Required
- Additional Liabilities
- Capital Tied Up in the Property

Owning a property also gives you control of what you want to do in the space. You don't have to worry about getting approval from anyone other than yourself.

In the area of buying vs. leasing commercial real estate, there are also some disadvantages to buying a commercial real estate building. Purchasing any property requires a sizable down payment, which could be as much as 40 percent of the total cost of the building. If your business is relatively new, it may be difficult to obtain a mortgage at favorable rates. There could also be prepayment penalties if you want to sell the building because you need more or less space.

With buying or renting office space, there is additional liability involved when you own a commercial building. Many of these liabilities can be covered through insurance, but personal guarantees are not. A personal guarantee means that you are personally responsible for the mortgage payments if the business is unable to cover the cost.

The last major factor to consider when choosing between buying and leasing commercial real estate is how much capital you would have tied up in the building. A commercial building is not a liquid asset, and if you had to sell your property in unfavorable market conditions like when interest rates are high or there is a lot of inventory, you could end up selling the building at a loss.

This is a broad overview of the pros and cons of buying commercial real estate, but every situation is different when deliberating between buying vs. leasing commercial real estate. McBride's team of experts have an average of more than 20 years of experience in the commercial real estate industry with vast knowledge of using creative real estate solutions like sale-leaseback transactions, and we can help you decide what's right for you with our commercial real estate brokerage services.

Leasing: *For Tenants*

Pros and Cons of Leasing Commercial Real Estate

When choosing whether to buy or lease commercial property, one of the reasons many business owners prefer to lease is that it gives you flexibility. As a tenant, you are only committing to be in a space during the term of the lease. If you are happy with the space, you will hopefully have the option to renew the lease. But, if your situation changes and you require more or less space, you would be able to move to another location. If you own the property, you are at the mercy of market conditions to determine if you sell the building at a profit or loss.

Another factor in deciding to buy or rent commercial property is that, in many cases, the owner of the building is responsible for building maintenance. When you are leasing a commercial space, while you may be charged for the cost of repairs, it is unlikely that you will have to oversee the project.

A financial consideration when determining whether to buy or rent office space is having capital tied up in a property and building equity. If you own a commercial real estate property, you will likely have a considerable amount of capital invested in the building, which becomes a non-producing asset. As the owner, you could also consider a sale leaseback transaction. If you are renting the space, your capital is available to further develop your business.

Leasing Commercial Real Estate

PROS: +

- Deduct Rent Payments
- Flexibility (Stay or Leave)
- No Building Maintenance

CONS: −

- No Property Equity
- Rent Increases Overtime (FMV)
- Difficult Landlord
- Adhere to Building/Property Rules

However, as a renter, you don't build equity in the property. While you're able to deduct rent as an expense, there is no value added for your firm. Your rent will likely increase over time, with the owner setting it at an amount they deem appropriate. Leases with options to renew often contain a provision that the rent will be at fair market value, rather than a fixed increase. In today's industrial market, rents increase on average between $7 and $8 per square foot. A few years ago, it was approximately $17 to $18 per square foot on average — a more dramatic increase. Owning a property with a long-term mortgage allows you to project what your payments will be.

When leasing commercial real estate, you may have to endure a difficult or unreliable landlord or property manager. You don't have control of the space you occupy, and you may not be allowed to make modifications. There are many other requirements in a leased property that will not be for you to decide, and you will have to follow and agree to the rules and regulations of the building. This could include the times when the HVAC is operational, days that the building is closed, the ability to bring a pet into the building, and a myriad of other policies.

When considering the options of buying vs. leasing space, there is no simple answer, and you need to determine what will be best for your company's future, not just for the short term. Our best advice is to work with an experienced commercial real estate brokerage firm that can guide and advise you on the options available. The experts at McBride Corporate Real Estate have been advising clients since 1959 and can discuss the various opportunities and help you decide what is right for you.

What is a Commercial Lease?

Someone knowledgeable in legal semantics or commercial real estate terms would probably describe a commercial lease as a contract by which one party conveys real estate, equipment, or facilities for a specified term and rent. And they would be correct, to a point. If you look beyond the sea of "whereas," "heretofore," "notwithstanding anything to the contrary," a commercial real estate lease takes on an entirely different persona. To define a commercial real estate lease more accurately, we describe it as a document that limits the rights and increases the obligations of a tenant and enhances the ability of a landlord to receive more than that which is afforded by law. To put it even more simply, almost every word or phrase in a commercial lease puts the burden on the tenant and relieves the landlord.

A commercial lease is viewed by courts very differently than a residential lease.

Typically, the landlord's attorney is the one who prepares a lease, so it makes sense it would be drafted in the landlord's favor. A commercial lease is viewed by courts very differently than a residential lease. Courts see the document as a contract between two equals, with each party negotiating in their own best interest, unlike a residential lease, where the courts almost always favor the tenant.

In a commercial lease, the parties agree on the rentable square footage of the property, and they cannot question it after the lease has been executed. Office space has three methods of calculating square footage: the useable, the rentable, and the carpetable. The useable square footage is easily determined; it is typically calculated as length multiplied by width of the space. The rentable square footage considers the common areas of a building: the lobbies, bathrooms, stairwells, janitor closets, etc., and then identifies an often-arbitrary percentage that is added on to the overall square footage, usually increasing it by as much as 18 to 35%. The carpetable area is a bit of an antiquated calculation, but when it was used, it accounted for wide heating ducts against windows that could take up as much as two feet around the perimeter of a space. Tenants are charged for rentable square footage, not useable.

Tenants are charged for rentable square footage, not useable.

Of course, the best way to navigate through a large commercial real estate lease is to have a skilled real estate broker who specializes in commercial real estate guide you through this process. The team at McBride has been in the commercial real estate business for more than 70 years, and we are well equipped to assist you in the process.

My Lease Expires in 24 Months.
What Should I Be Thinking About Now?

You're two years out from your lease expiration date. That means it's time to start thinking about next steps. From your vantage point, this might sound like a silly thought: you still have almost forty percent of your lease obligation remaining. Why should you be planning this far ahead? The truth is, when you stop to analyze the various scenarios and the length of time each can take, it's not too early, and today I'll tell you why.

Let's start with the facts.

Once your lease expires, you have five options:

1) **Stay** where you are
2) **Move** to the same size space in another building, either as an upgrade to your current situation or to reduce your rent
3) **Take more** space
4) **Take less** space
5) **Close down** the business

In accordance to commercial leasing laws, you can't stay in the space after your lease expires. If you do, the landlord, by statute, can charge you two times your current monthly rent. I'm guessing that's something you'd rather avoid.

Your most viable option: move to another space – a process that includes a number of components, which, taken together, can span the better part of two years.

Let's explore each phase in detail.

Identifying the new space.

As you consider where you want to go next, you'll need a month or so to identify your current and future needs. To do this, start by asking yourself the following questions:

- What works well in your current space?
- What would you like to change?
- Do you need more/fewer workstations and/or offices? If so, how many?
- Does the building suit your geographical needs? If so, why? What about this geography works for you?
- Does your current space convey an image that supports your brand – one that you're proud to present to customers?
- What are your cost needs and rental budget moving forward?

With a clearer picture of your needs, you'll be ready to tour the market. Here is a timeline for finding your new commercial space.

30 days – at least, to find buildings that you like.

30 days – for the LOI (letter of intent). Typically, I like to give at least two, if not three, LOIs to the buildings of choice so we can identify where the best deal will be. No need to commit to one building at this time.

Finalizing the lease and planning the space.

After you've identified a building and agreed on the terms, the landlord will prepare a lease. Typically, the larger the space, the longer the lease.

30 days – This step can generally get accomplished in 30 days. But if it requires more time, you can generally grab some extra days from other stages in the process to make up days.

2 weeks – With the lease executed, your next step is to plan with the building architect. They will need at least two weeks to craft plans, then another two weeks to modify them. With your approval, they will then prepare construction drawings (also known as signed and sealed plans).

Here's where the process slows down.

6 weeks – It can take six weeks for a town to approve your plans – and that's assuming they make no changes. If they do request changes, plan on another 30 days for final approval. While this part of the process requires patience, you can use this time to start sending the unofficial plans out to contractors for bids.

Preparing your space and moving in.

90 to 120 days – With plans approved and a contractor hired, the construction can begin. Depending on the complexity and scope of construction required, this can take 90 to 120 days to complete.

The space is now ready for you to move.

How much time has passed? Nine and half months have elapsed from the first thought of your lease expiring – if everything goes smoothly.

I ask you now: Is 24 months out too premature to be thinking about future space? Granted, two full two years may be on the early side, but by the time you're 15 months out from your lease expiration, you should be well into the process.

Landlords don't like empty space. This is the time that you can push for the best deal, since you're not under any pressure. And what could be better that?

Why Landlords
Want to Hang Onto Their Tenants

"Knowledge is power." Those words coined by Francis Bacon in 1597 still ring true today – particularly when it comes to deciding whether to renew your lease or move on.

Let's assume for this exercise that your current space is functional for your purposes. As a tenant, you stand in a position of strength in today's market. In recent years, firms have started to cut back on space in favor of a more predominantly remote workforce – a trend that was only exacerbated by the pandemic. Your landlord does not want to lose you as a tenant; finding a new tenant is far more costly.

Think about it: even if your space is in relatively good condition – in need of a few updates – your landlord will still lose money in this scenario. First, there's the time-lapse between when you move out and a new tenant moves in. Let's put that at a month – minimum! Throw in permits and inspections, and you're looking at three months – and that's assuming there is a lease in place for the new tenant before your existing lease expires.

> Your landlord does not want to lose you as a tenant; finding a new tenant is far more costly.

Let's say you're paying $24.00 psf for a 4,000 sq. ft. space. That's $96,000 per year, or $8,000 per month. If you vacate that space, your landlord stands to lose as much as $24,000 over the three months while the space is retrofitted to the new tenant. For a modest fit-up (e.g., moving a few walls, painting, carpeting, installing LED lighting), your landlord is easily looking at $20.00 psf, at least. That's another $80,000.

Then there's the cost to prepare and negotiate a new lease, which comes in at around $4,000. A simple lease extension cost, on the other hand, is nowhere near that amount. The delta between what it could cost an owner to lease space to a new tenant and keeping an existing tenant could be more than $100,000 – and we haven't even touched on free rent for a new tenant.

Now let's say you stay in the space, but you'd like a few updates. Here's where your power comes in. You now know that leaving altogether, versus asking for the upgrades, will cost your landlord significantly more. As a tenant, what's your play? How do you make sure you're getting a good deal from your current landlord? First, hire a commercial broker to represent you. (More on this another time.) Next, go into the market and see what comparable offers are being made by competing buildings. Just as you're going to want enticements to move to another building, so would future tenants look to your existing landlord for additional incentives to move there.

The vacancy rate in office space in Northern NJ is currently 23.2%, according to CoStar, a database that tracks occupancies. But that doesn't tell the complete story. If you were to look for a 3,000 - 5,000 sq. ft. office space within five miles of Paramus, NJ, you've got about 140 buildings to choose from. While one might argue that's a 75% advantage to the landlord, the real odds are one out of 140. The question becomes, who has the upper hand? In my opinion, landlords really need to consider and appreciate the true value of their current tenants.

What Is a Commercial Sublease
– A Tenant's Rights and Obligations

Subleasing a commercial space means renting out a property you have already leased to another party. The right to enter a commercial sublease is one of the most important clauses in a commercial real estate lease. Commercial leases often favor the landlord since the document is usually authored by the property owner's attorney. But there are some elements you should pay close attention to before signing a commercial space lease.

Unlike residential leases which usually cover a time of one to two years, most commercial leases are for a longer period, with at least three to five years being the norm. With the cost of construction skyrocketing in recent years, many owners are favoring 7- to 10-year leases if the tenant requires major construction in their spaces. Which is why it is essential you have the right to secure a commercial real estate sublease or assign the lease before it is executed.

The landlord typically includes wording that requires the owner's approval before the renter can enter a commercial sublease. The wording will vary – it could be fairer to the tenant if it reads such as, "the tenant needs to receive the landlord's approval, which shall not be unreasonably withheld, conditioned, or delayed." Or the landlord could be less lenient and include language like, "the landlord may withhold its consent in its sole and unfettered discretion." It is always helpful to add in parameters if possible.

Landlords usually add in a clause that requires the tenant to pay the landlord's legal fees for reviewing a commercial sublease. We recommend tenants look to remove that clause or, at the very least, settle on a dollar amount cap required to get approval.

Another factor to pay attention to is who gets the profits that may result from the commercial sublease. In many cases, the lease will state the landlord has the right to receive all or part of any profit the tenant derives from the subleasing of the owner's space. But what constitutes profit? Is it simply the excess amount of rent the sub-landlord receives? Or could there be other factors that would allow the sub-landlord to have the sub-tenant pay more rent and yet it not be profit? We will discuss this topic in greater detail in part two of this article on a commercial sublease.

There are some ways to minimize a profit owed to a landlord and yet still produce extra rental income for the sub-landlord including:

- **Deducting the rent** that would have been paid had a sub-tenant been in the space while the space was vacant
- **Any improvement allowance** given to the sub-tenant
- **Any free rent** given to the sub-tenant
- **Lease takeover payments**
- **Attorney fees**
- **Brokerage commissions**
- **Costs of advertising**
- **Unamortized cost** of initial and subsequent improvements to the premises.

Again, keep in mind that a commercial lease isn't intended to be fair for all parties – it is written to benefit the property owner. A commercial real estate lease places most of the obligations and responsibilities on the tenant and causes the tenant to give up some of its rights afforded by law. Which is why it is imperative to understand what is included in the lease as written and negotiate where possible, especially when it comes to commercial subleases.

McBride Corporate Real Estate has been serving corporate America's real estate needs since 1959. If we can use our deep expertise in commercial real estate brokerage to help you navigate a commercial sublease that's right for your business, please contact us today.

Leasing: *For Landlords*

The Perils and Pitfalls of Operating Expense Clauses in a Commercial Real Estate Lease

When I was a young broker in the late 1980s, I attended a dinner where a number of real estate developers spoke. When asked about operating expenses, one of the speakers, who was a New York City landlord, answered that any property manager who doesn't make a ten percent profit on operating expenses he charged to his tenants is not doing a good job.

Famed hotel owner and convicted felon Leona Helmsley once charged the repainting of her home to one of her buildings, burying it in the commercial operating expenses of a building she owned. In actuality, the tenants of the building paid for the cost of her repainting.

In a similar vein, I once learned of a property owner who would purchase art for a building he owned. After a year or two, he would replace the art with new pieces and display the old pieces in his home. Once again, the tenants paid for the owner's collection.

Operating expense pass throughs, commonly referred to as OPEX, can be a useful tool to help cover landlord expenses in financing the maintenance and operation of a commercial property. But there can be some challenges associated with a pass through in a lease – hence the title of this article.

Under the terms of a pass through in a lease, whether it be for the primary lease holder or someone subletting a commercial property, the property owner has the right to pass along to the tenants of a building the commercial real estate operating expenses, or the cost of the various components of operating the building. Each tenant pays its proportionate share of expenses based on the space they occupy in a building in a multi-tenanted building, or all the expenses if a tenant is the only one in a building. The landlord is able to charge, under the commercial lease, operating expenses such as real estate taxes, property insurance, electricity, snow removal, landscaping, and a number of other items that are outlined in the lease agreement between the parties.

On a gross lease, where the OPEX is included in the base rent, a tenant typically pays increased expenses over a base year, usually the year the tenant moved into the building. However, this can become a negotiating point while discussing a pass through in a lease. You may also be able to negotiate the date on which that base year begins.

What OPEX should you pay attention to when there is a pass through in a lease?
Here are some other items to get clarity on when negotiating a lease with a pass through:

- If a mechanical service to the premises needs to be repaired or replaced, is the tenant responsible for the cost? Does that change depending on where the tenant is in their lease, i.e., have only a few months remaining?

- Are capital improvements, such as a new roof, repaving a parking lot, or items of that nature being charged to tenants as an ordinary expense or as a capital expense, which should be charged to the tenant over the useful life of a repair or replacement according to Generally Accepted Accounting Principles?

As you can see, a pass through in a lease is a nuanced area of real estate transaction that leaves you vulnerable to problems. It is essential for you to speak with a qualified commercial real estate broker to guide you through the labyrinth. At McBride Corporate Real Estate, we have been working with tenants and the issues they face in negotiating commercial leases since 1959 with most of our brokers having at least 20 years of experience in commercial real estate.

Sale-Leasebacks

Sale-Leasebacks: How Does the Seller Benefit?

Sale-leaseback transactions have experienced record activity in recent years. But what exactly is a sale-leaseback – and what's the draw? Sale-leasebacks are multi-faceted and involve a myriad of intricacies. Today we will delve into this complex but important topic in the first of a four-part series that explores its advantages and disadvantages.

As the term would suggest, a sale-leaseback occurs when the owner of a building sells a property they currently occupy to an investor, then leases that space for an extended period of time. In essence, the seller becomes the lessee, and the purchaser becomes the lessor.

What are the upsides? Let's look at it from the seller's vantage point:

Frees up capital:
By turning a non-liquid asset into a liquid asset (cash), a sale-leaseback frees up capital for the business. Owning a building that has appreciated in value is great – but that value is sitting in the building. If you refinance it, you'll only get 65 to 80 percent of the building's value, whereas selling it will get you 100 percent. (Note: this scenario does not take any existing mortgages on the property into account.)

With the sale-leaseback, the seller can now take the monies received and reinvest it into its core business – which for most businesses is a better use of cash than real estate appreciation. At the same time, it allows the seller to stay in the building – so they don't have to deal with the hassle or the expense of relocating operations.

Benefits your balance sheet:
In a sale-leaseback, the seller replaces a fixed asset (the real estate) with a current asset (the cash proceeds from the sale). Plus, the line item for rent is only reflected for the current year, which increases the seller's ratio of current assets to current liabilities. A higher ratio may help the seller obtain short-term financing at better rates.

Additionally, many companies have restrictions on borrowing additional funds based on prior agreements. However, because rental payments usually aren't considered debt, a sale-leaseback would prevent the company from violating those previous agreements. What's more, by selling a property and leasing it back, the seller could potentially thwart a takeover that was based on undervalued real estate.

Helps with taxes:
There are many tax advantages to the seller in a sale-leaseback. But as a real estate broker, not a CPA, I'll only delve into one today: deductions. When you rent a building, you can deduct the cost of the rent. But when you own, only the mortgage interest and real estate taxes can be deducted.

Sale-Leasebacks:
What's in it for the Buyer?

For a successful sale-leaseback to occur, both the seller and the buyer need to benefit from the transaction. In the first of our three-part series, we highlighted the advantages to the seller. Now, we're exploring the topic from the buyer's perspective.

Typically, leaseback leases are constructed as a triple net lease, whereby the tenant pays the taxes and all operating and maintenance costs for the building, including repairs. Assuming the tenant continues to pay rent on what will generally be a 5- to 10-year lease, the purchaser will benefit from a guaranteed rate of return on investment – higher than a conventional mortgage arrangement.

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The sale-leaseback is usually put together based on the rate of return for the purchaser. Let's say you are being offered a 50,000 sq. ft. building at a capitalization rate of 7.25%. The deal can be structured to allow the seller to receive a higher sale price of $180 per sq. ft. or $9,000,000, then pay a rental rate of $13.05 sq. ft. If, on the other hand, the seller wanted to pay a lower rental rate, say $8.00 per sq. ft., the building would then sell for $5,517,240. In both cases, you'd receive an initial return of 7.25%. The capitalization rate is always the driving force in the transaction, otherwise, you'd be looking at a seller who wants the highest sale price with the lowest rent and a buyer who wants the exact opposite.

What's more, when you purchase a building as a sale-leaseback, you get to accrue the appreciation of the space; the tenant does not share in any upside in value. If you obtain a mortgage for the building, your rate of return will increase based on the cash outlay. It should also be noted, in a sale-leaseback, if the seller defaults in making lease payments, you'll be able to get a default judgment to evict the new tenant without having to go through a foreclosure proceeding.

A sale-leaseback with a quality tenant is generally a sound investment, providing security, positive returns and an upside in potential appreciation.

The Disadvantages in Sale-Leasebacks

As with all things that have positive aspects, there are also some negative implications that one should be aware of before entering into a situation such as this.

The negative aspects, while few will be discussed below. First, the main disadvantage to the seller is that he no longer is in control of his real estate destiny. The seller now has a lease in place with a definitive time frame for its termination. If there are no options to renew the lease, the seller, now the tenant will have to vacate the property. Even if there are options to renew the lease, if they're at Fair Market Value, the seller may find itself paying far more than anticipated when the time to renew the lease occurs. The seller also may be restricted as to what they can do with the building. What approvals will they need to receive from the buyer to make additions or modifications to the building? If the seller wants to finance modifications to the building, they no longer have the building to use as collateral. Any increase in the value of the property, no longer is the seller's; that all ends at the closing.

The biggest risk to the buyer is that the seller defaults in the payment of rent. As was noted in the earlier article, while this is certainly a risk, it's much easier to remove a tenant that defaults on a lease than to foreclose on a mortgage. Another risk to a buyer is that they need to make sure that the tenant is paying real estate taxes and the general up keep of the building. While this too can be added into the rent to ensure that it is done, there's an added cost to the buyer to do this. There also is a tax consideration. When the buyer is collecting rent, the entire payment is taxed as ordinary income. While if it were a loan, only the interest would be subject to tax and not the principal being repaid. That's a very simplistic view of the tax ramifications, and one should consult with their financial advisors. I'm a broker and am neither an accountant nor a tax attorney, and as such, my expertise is in the business terms of the transaction, not the tax implications.

To sum this up, sale leaseback deals are very good investments for many people on both the sale and the buy side. This, like any other financial transaction, should be carefully studied, and surrounding yourself with knowledgeable advisors in law, accountancy, and real estate brokerage is certainly the way to go.

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