Fundamentals can help keep money flowing

COMMERCIAL REAL ESTATE

As I pen this, we are halfway through July 2022, and Christmas decorations should replace patio furniture displays at Costco next month.

These days, it seems we have two times of the year — before Christ-mas and after. Before starts Aug. 1 and after on Dec. 26. Every-thing else is just a footnote. So much has happened in the world — after Christmas.

We've seen commercial real estate values eclipse sanity, two quarters of declining GDP (read: recession), inflation is the highest it's been since 1982, Russia invaded Ukraine, gasoline rose above $6 per gallon, food shortages, mass shootings of innocent schoolchildren and their teachers, brick-and-mortar retail foot traffic slowing to a crawl, interest rate hikes, residential activity in a freefall and rumors of slowing in our own commercial market.

How things have changed! And in a heartbeat.

However, one thing that stays constant is commercial real estate fundamentals. You know, those pillars from which we base our direction. In a changing market, it's helpful to keep these pillars in mind.

One fundamental pillar is the lease agreement. Whether renewing an existing arrangement or originating a new deal, the following should help you bend with the changing times.

In my experience, there are at least five "gotcha" issues that should be addressed in any lease agreement. The Association of Industrial Real Estate lease, in my opinion, addresses these issues quite thoroughly — with a few tweaks. In the case of an owner-generated lease, the issues vary in their treatment.

The five issues are operating expenses; capital expenditures; subordination, non-disturbance and attornment; rent increases; and miscellaneous. I will define each issue and suggest "asks" during the lease negotiation.

Below is a layman's review as a practitioner and should not alleviate the need to have all legal documents reviewed by counsel. These issues are from a California perspective and may vary by state.

Operating expenses (industrial)

Operating expenses, also known as op exes, are the expenses an owner incurs in the operation of a property. These expenses include, but may not be limited to, property taxes; property insurance; maintenance of the foundation, roof and walls; landscape maintenance; maintenance of the building's systems (plumbing, electrical, HVAC, etc.); utilities; and the occupants' share of the amortized capital expenditures.

The costs are sometimes referred to as NNN expenses, or "grossups." Such expenses vary greatly based on an owner's and future financing that is placed on the property.

As a tenant, a request that the lease is non-disturbed (terms not modified), should be sought in return that the tenant agrees to attorn (recognize) an owner that becomes the owner through the foreclosure of the underlying debt.

Requiring ALL of these is important, in my opinion, especially during economic times that could suggest a high likelihood of foreclosure.

I suggest the lease clearly provide for ALL of the components — S, ND and A, and that where possible the lender be persuaded to sign an SNDA recognizing the lease.

Rent increases

These are defined as increases in the rental schedule during the term of the lease.

Generally, the increases are throughout the term of the lease and could vary based on the change that occurs in the CPI or a fixed annual amount.

Throughout 2021 we saw these fixed amounts escalate. Recently, a lease was written with 5% annual bumps! That's almost double the amount we saw in 2019.

Caps and floors are always suggested to hedge against a rampant inflationary increase.

Miscellaneous

Former and existing cabling removal, Americans with Disabilities Act — ADA requirements (and who is responsible), city permitting, subleasing and assigning, rent abatement versus free rent, and options to extend and purchase should all be carefully vetted and when necessary, negotiated.

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management preferences but are largely skewed by the amount of property taxes.

If you negotiate a NNN lease, the costs are paid in addition to your rent either as due or monthly. If the lease is an industrial gross lease, the base year op exes are included in the base rent.

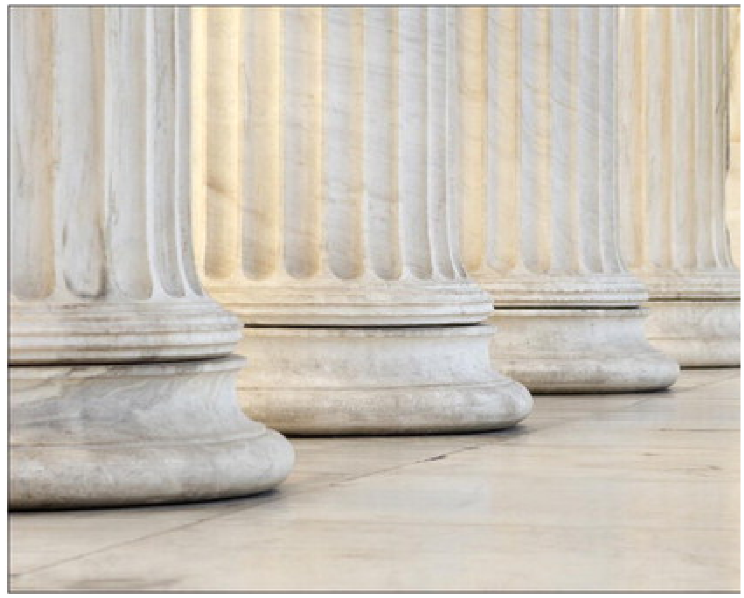
I suggest postponing the base year until the first full year after the commencement of the lease. If the lease commences in February, this is a tough ask. If the lease commences in October, not so much. I suggest asking for a cap on the increases in op exes over the base year.

Capital expenditures

Capital expenditures are expenses that are largely nonrecurring such as roof replacement, parking lot replacement, drive and landscape modifications. I suggest there be a mechanism in the lease to specify any expense exceeding 50% of the cost to replace a capital system (roof), be the responsibility of the owner and the cost be amortized over 12 years at an agreeable rate of interest.

Subordination, non-disturbance and attornment

This is defined as the financing holder's means of securing their interest and the outcome of any foreclosure. Also known as an SNDA, this clause causes the lease to be subordinate to existing



One thing that stays constant in commercial real estate is the fundamental pillars from which insiders base their direction.

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