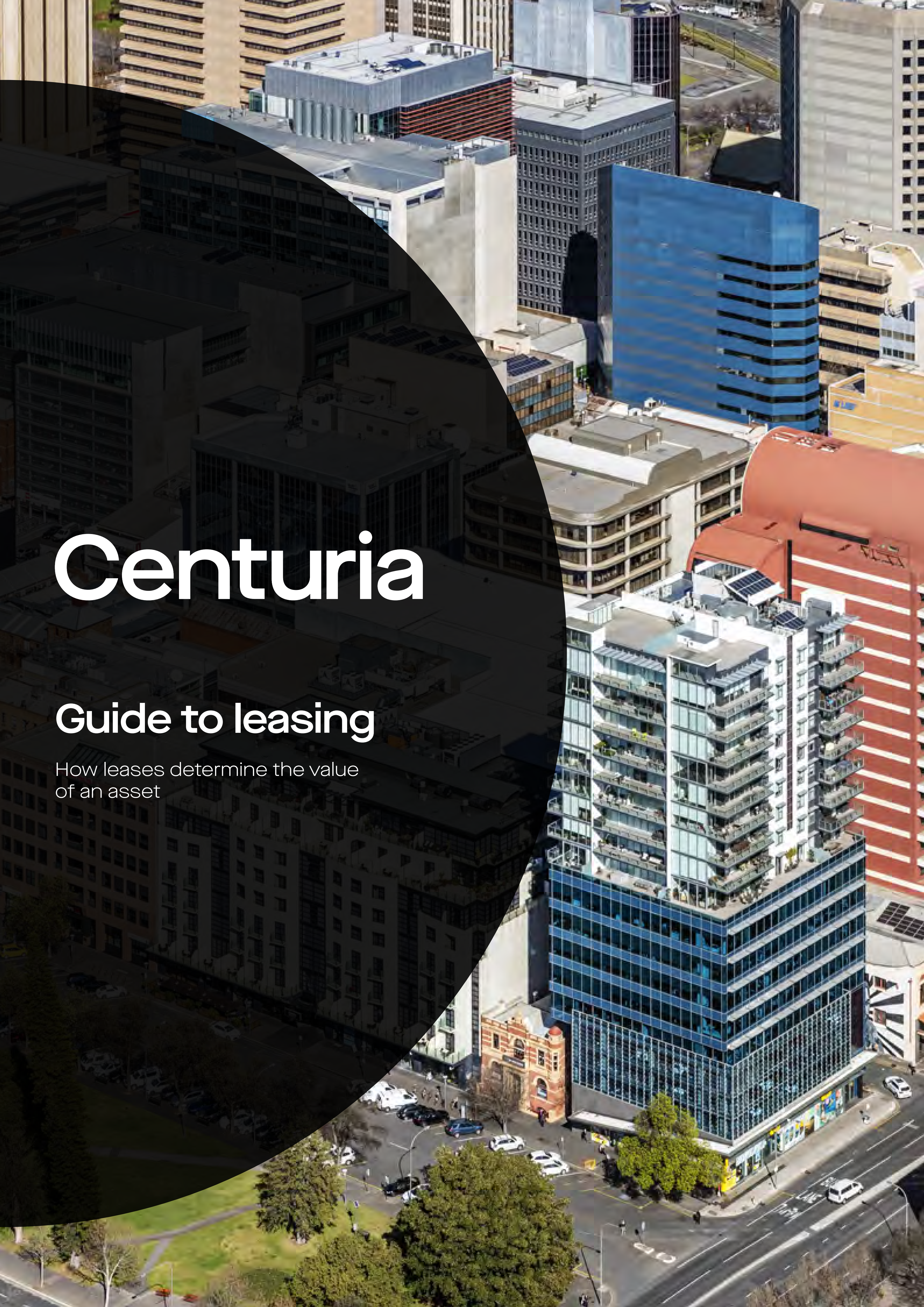
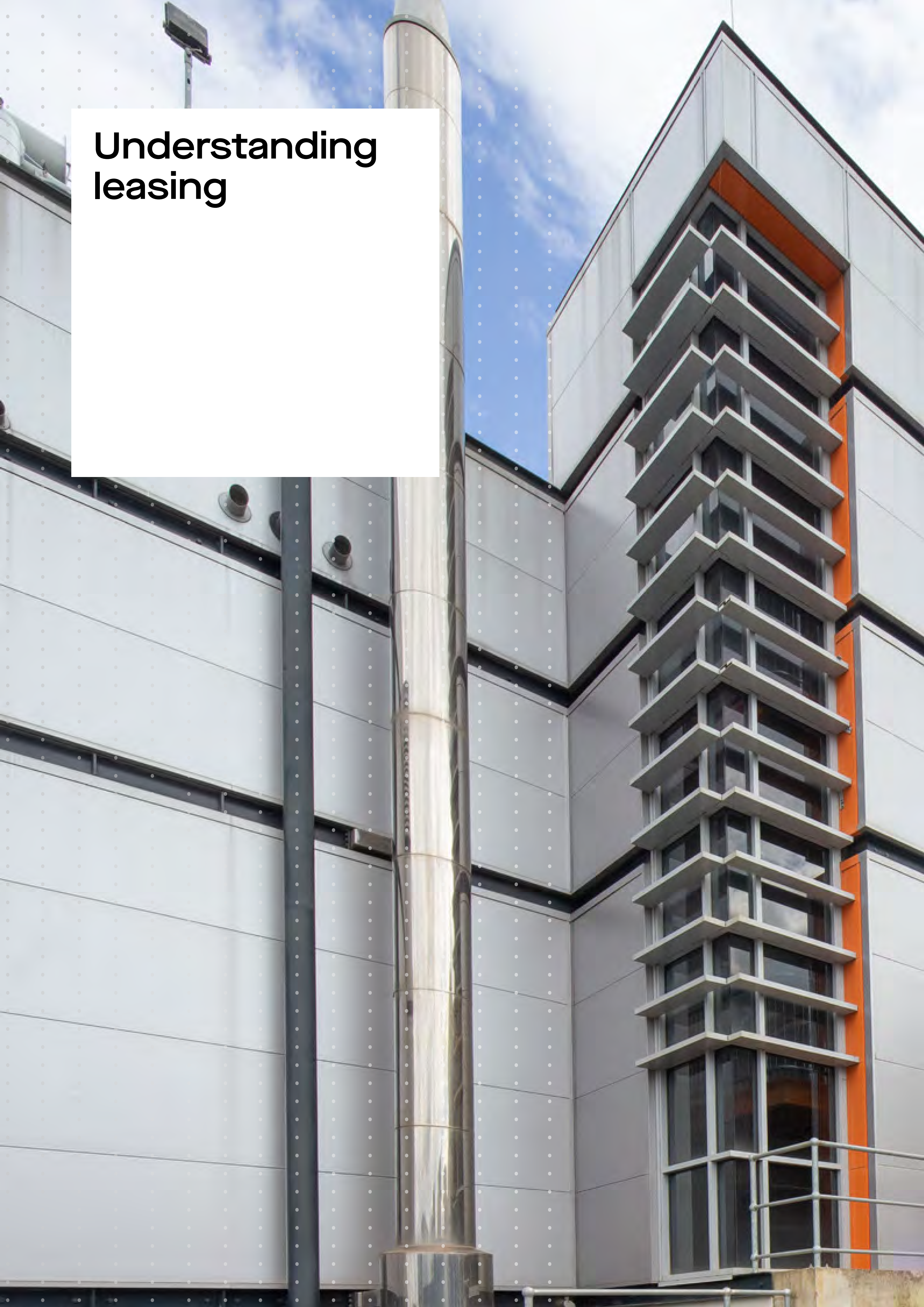


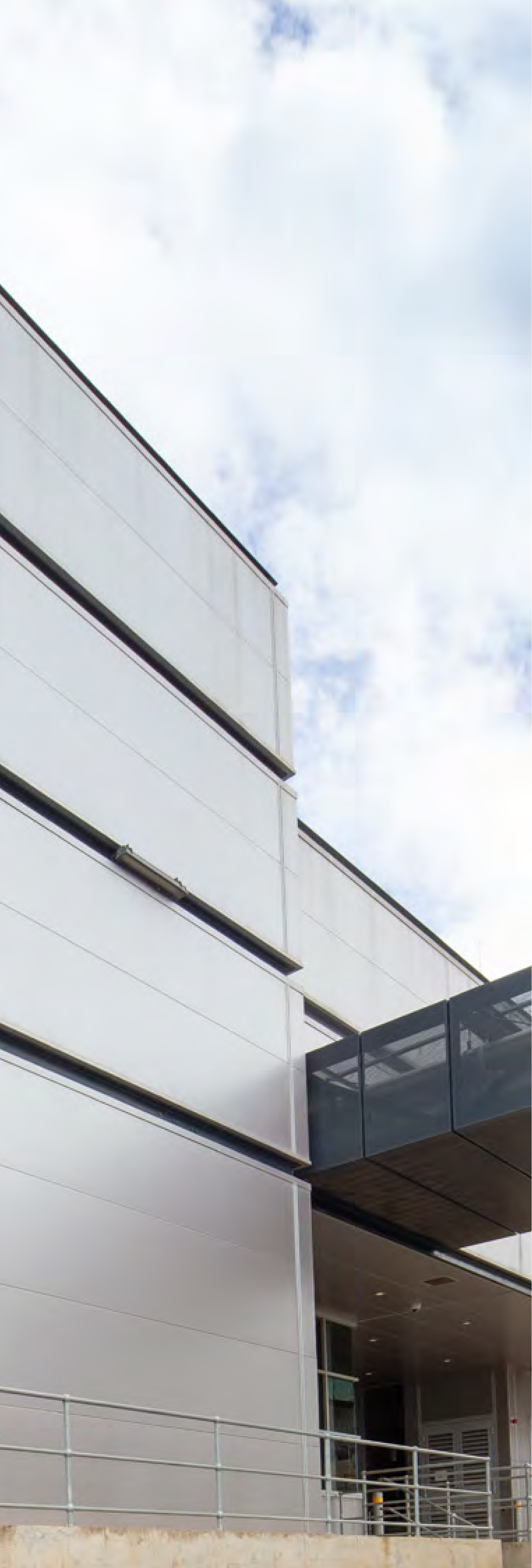
Centuria

Guide to leasing

How leases determine the value
of an asset

Understanding leasing





For investment grade properties, it is the lease or leases of the property which determine the rental income and ultimately the end value of an asset, coupled with the capitalisation rate or yield which an investor will accept for that same asset.

Aside from the rental rate itself, there are four key components which typically comprise a lease deal.

- Lease term
- Rent review
- Tenant incentives
- Lease guarantee

Lease term

For commercial property, the lease term (term certain) is typically between 3 and 10 years.

In addition to the term certain, an option period is often negotiated. An option period allows a tenant to 'exercise' its option to extend the lease term for a further period. In all but a few instances only the tenant (lessee) can exercise an option to extend the lease, not the landlord (lessor).

In an uncertain economic climate, the WALE of a property often dominates discussion relating to the value and market appeal of a commercial property. The acronym WALE stands for Weighted Average Lease Expiry.

Essentially, the WALE of a property indicates the average (weighted) number of years before leases in the property expire and need to be re-set or re-let.

Unless the property is significantly under-rented (rented at substantially lower rents than prevailing market levels) or has a higher and better redevelopment use, an asset with a longer WALE is preferred by the investor market. This is because a longer WALE is considered to represent a higher level of income security.

A multi-tenant property would typically have a WALE of anywhere between two and five years.

Rent review

Most leases have rent reviews during the lease term.

The review mechanism negotiated between the landlord and the tenant is generally based on either a:

- Fixed Percentage
- CPI
- Market
- Combination of the above

In most cases, the rent review is conducted annually.

A Fixed Percentage Review is the most common method agreed to in commercial leases. The advantage of this method is it allows both the lessor and the lessee to budget for future income (in the case of the lessor) and rental expenses (in the case of the lessee) with certainty. The disadvantage is that it does not necessarily move in line with either the CPI or the market – which may lead to an over or under rented property.

A CPI Rent Review is a review whereby the lease rental is adjusted to the change in the 'Consumer Price Index' over the period between the current rent review date and the previous rent review.

The advantage of a CPI rent review is that the change in the rent levels will track inflation or the 'cost of living'. The disadvantage is that there is no certainty of where the rent levels are headed for either the landlord or the tenant. That is rents can go up or down by any amount.

A Market Review is when the lessee's rent is reviewed to the then current market rental taking into consideration the quality of the property, its location and the size of the specific tenancy in relation to the rent achieved in comparable properties. Most commonly, market rent reviews are only conducted if and when a tenant exercises its option for a further term and not at the (annual) rent reviews during the term certain.

Tenant incentives

If a leasing market is over-supplied or is operating within a challenging economic climate or the property itself is in a condition or of a design or in a location which is unappealing to a typical tenant within that particular market, a landlord may have to offer a prospective tenant a financial inducement or incentive to enter into a lease over that property.

Incentives can be offered via a number of formats however three of the more common incentive structures are rental abatements, rent free periods or cash contributions to a tenant's fitout (or a combination of these).

The incentive is normally calculated in percentage terms and can be based on either the net or gross rent the tenant is to pay in year one, multiplied by the number of years of the lease.

For example:

If a tenant is contracted to pay $100,000 pa in Year 1 of a 3 year lease term, ie the total rent for the term is $300,000 (excluding rent reviews), and the tenant is offered a 15% incentive, then the value of the lease incentive equates to $45,000.

$300,000 (total rent) x 15% (incentive %)	= $45,000 (incentive in $ terms)

Therefore, if the incentive is taken by the tenant as a rental abatement, the tenant will receive a monthly rental rebate (discount) of $1,250 over the term of the lease.

$45,000 (Incentive) /36 months (Term)	= $1,250 pcm (Abatement)

If the incentive is taken by the tenant as a rent free period, then typically under this method the tenant will not be obligated to pay rent for the first portion of its initial term to the value of ist incentive. In this example:

Rent	= $100,000pa or $8,333.33pcm
Incentive	= $45,000
Rent free period	5.4 months ($45,000/$8,333.33) over the 3 three year term

If the incentive is taken by the tenant as a cash contribution to fitout, the landlord will pay the tenant the cash amount of the incentive. In this instance the incentive is 'extinguished' upon payment and the tenant pays the landlord rent from day one of the lease.

Lease guarantee

In the majority of leasing transactions, a guarantee of some form is obtained from the tenant as security over the performance of its lease obligations.

Standard types of lease guarantees include a bank guarantee, a rental bond, a personal (directors) guarantee, a parent company guarantee or a combination of any of these.

The most preferred of these guarantees is a bank guarantee.

A bank guarantee effectively provides 'cash on demand' should the tenant default under its lease.

Know your risks

As with any investment, there are risks to investing - and these should be understood. Some factors to consider when investing in listed and unlisted property funds include, but are not limited to, stock market volatility, the liquidity of the fund, the gearing of the properties in the fund and understanding the individual properties held by the fund and their characteristics (e.g. tenant demand, property valuation metrics, cash flow sustainability etc).

It's important that you have a manager who has experience managing and mitigating these risks where possible. A critical part of the success of property investment is the quality of the ongoing management of tenants and the physical aspects of the property, both of which we consider to be strengths within our business. In addition, capital gain potential is maximised by ensuring the most efficient use of space, conducting services upgrades, building refurbishment and assessing potential re-development. The majority of our portfolio is managed by our in-house property division. Our team is comprised of experienced property professionals with backgrounds in leasing, agency and valuation. Any property managed externally is managed by hand-picked experts in their locations and asset types.

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FURTHER INFORMATION

For further information on Centuria's property offerings and to aid your clients in their property investing decisions visit **centuria.com.au** or speak to a member of our property team on **02 8923 8923.**