FEATURE

Valuation of leased income-producing properties exhibiting excess rent

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Above-market rents are often encountered in the appraisal and analysis of leased income-producing properties during periods when real estate markets are over supplied.

For example, an existing lease may have been negotiated in a more buoyant market or under terms and conditions favouring the landlord. Even recently negotiated leases are commonly found to reflect above-market rental rates artificially and deliberately inflated by the landlord in exchange for a variety of tenant inducements in an attempt to enhance the value of the property for a host of self-serving reasons.

When achievable economic or market rent levels for competing space have declined, and the decline is viewed as more than just an aberration, the impact on the valuation of an income-producing property that is under contract at an above-market rental rate must be taken into account. Since above-market rents are not sustainable indefinitely, they must be properly addressed and executed to ensure that properties with such lease characteristics are not over valued through inappropriate treatment of the excess rent in the valuation process.

Many landlords and developers deliberately structure tenant leases at rent levels that substantially exceed economic or market rents to artificially inflate the underlying value of their real estate holdings on the expectation of achieving higher loan amounts and/or higher market prices upon disposition. Some of the more common leasing practices which contribute to excess rent include the provision for free rent periods, postponement of rental payments, postponement of operating expenses, cash inducements, installation of leasehold improvements, and construction of custom buildings, all of which are ultimately paid for by the tenant in the form of above-market rents.

In the case of some real estate syndications, it is not uncommon for the syndicator or general partner to artificially inflate rentals which, in turn, are guaranteed by the general partner for a short period of two or three years as a means of enticing investors to the project at prices that substantially exceed market value.

The following terms and definitions are intended to assist in providing a clear understanding of the fundamental appraisal concepts described and employed in the presentation of this article.[1]

Economic or market rent is the amount of rent that a property would generate if the amount was set by the market, as opposed to contract rent, which is specified in the lease.

Contract rent is the actual rental income specified in the lease, as agreed to between the landlord and tenant, and may be higher or lower than, or equal to, economic or market rent.

Excess rent is the amount by which the contract or lease rent exceeds the economic or market rent of a property, under similar terms and conditions of occupancy, at a specified point in time.

Capitalization in perpetuity is the process that converts an income stream (i.e., net economic income or net operating income) assumed to last indefinitely and not change (grow or decline) over time into an estimate of value by application of a rate (i.e., overall capitalization rate) or factor that measures the financial performance of real estate.

Fixed-term discounting is the process used to convert into present value periodic income (i.e., excess rent) that is only temporarily sustainable through application of a rate (i.e., discount rate) or factor and is based on the assumption that periodic income to be received in the future is worth less than the same periodic income if it were received now.

Fee simple is the interest in property recognized by law as denoting the highest quantum of absolute ownership rights, unencumbered by a leasehold (lessee's) interest or by any other interest in property.

Leased fee is a lessor's or landlord's ownership interest in leased property with the right of use and occupancy conveyed to a lessee or tenant for a stated term under stipulated conditions with the lessor retaining the right of repossession upon the expiry date of the lease.

Leasehold estate is the lessee's, or tenant's, interest in the right to use and occupy real estate (property) for a stated term under the conditions conveyed in the lease.

Market value is the most probable price, as of a specified date, in cash, or in terms equivalent to cash, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.

Property which is leased at above-market rental rates may be viewed as having both sustainable (economic or market rental component) and unsustainable or partially sustainable (excess rental component) rents. Accordingly, in the preparation of an appraisal of an income-producing property that is leased at above-market rent, the two components (economic and excess rents) which constitute the contract rent must be separately portrayed in the valuation and clearly convey the property rights that each component of income represents. Adherence to these basic appraisal principles should help to eliminate the possibility of over valuing an income-producing property which is leased at an above-market rental rate and to ensure that the results of the valuation are presented in a clear, concise and meaningful manner.

Prior to the commencement of an appraisal assignment, it is incumbent upon the appraiser/analyst to request from the client a copy of all relevant lease documentation, including original Offer to Lease and Amending Lease Agreement, and to obtain an undertaking that all arm's length leases are in good standing and that there has been no informal postponement of either rental payments or recoverable operating expenses. Sometimes, it may also be desirable to confirm the terms and conditions of each lease, including scheduled contract rents, with the tenants. Lease summaries typically fail to disclose important lease clauses or riders that may have an impact on value and are an inadequate data source from which to derive a thorough and detailed assessment of whether the contract rents are indicative of either economic or above-market rents when viewed in conjunction with external market research. The same degree of due diligence should be exercised in the research and analysis of comparable lease and rental data.

One of the most crucial steps in the valuation process of any leased property is to establish the prevailing economic or market rent for the leased space under similar terms and conditions of occupancy based on a comparative analysis of recently negotiated leases and/or current asking rents for competing space. (While during a rising real estate market one is likely to encounter a rental shortfall in a leased income-producing property, the intended scope of this article does not address such an occurrence.) Once it has been determined that the contract rent stipulated in the lease exceeds the economic or market rent and the amount of excess rent computed, an appropriate and relatively simple two-step valuation model can be constructed which will quantify individually the contribution to value of both the economic and excess rental components portrayed by the contract rent.

Capitalization in perpetuity, as a valuation model, theoretically recognizes economic or market rent as being sustainable indefinitely, unlike excess rent, generated by an existing lease that is financially favourable to the landlord, which is recognized as having a limited life expectancy that cannot exceed the remaining term of the lease. Therefore, only that portion of the contract rent that corresponds or equates to the economic or market rent can be capitalized in perpetuity.

Conventional appraisal wisdom holds that, if above-market contract lease rent equivalent to economic or market rent is replaced with economic or market rent in the valuation process, the estimate of value that is indicated represents the market value of the fee simple interest rather than the leased fee estate. As there is no explicit assumption of any lease termination or abandonment of the premises in the inferred fee simple posture, the exclusion of excess rent in an estimate of value might more appropriately be described as the market value of the leased fee interest at market or economic rents. To suggest that the substitution of contract rent (i.e., above-market) with economic or market rent produces a market value estimate of the fee simple interest while the lease is still in good standing may be inappropriate and unintentionally misleading.

RISK ASSESSMENT OF EXCESS RENT

Whether excess rent should be recognized and factored either partially or fully into any value estimate of a leased income-producing property depends on the appraiser/analyst's risk assessment of a number of value-influencing factors, including the following:

- strength of the tenant's covenant (i.e., credit rating of tenant);
- magnitude of the excess rental component (i.e., amount of contract rent in excess of economic rent);
- duration of the excess rental component (i.e., remaining term of the lease as of the date of the appraisal);
- collectability of the excess rental component (i.e., fulfilment of past contract rental obligations);
- market response to the excess rental component (i.e., recognition of excess rent by prospective investor-purchasers);
- ability to mortgage the excess rental component (i.e.,

lender recognition of excess rent to enhance the level of financing);

- ability of the tenant to renegotiate the terms of occupancy (i.e., either alter the terms and conditions of the existing lease or renegotiate a new lease);
- ability of the tenant to reman competitive (i.e., likelihood of business failure due to disproportionate allocation of earnings paid as excess rent); and
- supply of competitive space (i.e., inventory of competing vacant space, current vacancy rate, and likely levels of anticipated space absorption).

RECOGNITION OF EXCESS RENT AND VALUATION PROCEDURE

Excess rent, if recognized to any degree as a component of, or complement to, value, must not be projected to continue to flow to the property beyond the expiry date of the actual lease term. Treated as having a fixed term, excess rent must be isolated from economic rent and separately converted into an expression of value by discounting, at an appropriate rate, the excess rent expected to be generated by the property from the date of appraisal to the date on which the lease expires. In the absence of any definitive appraisal nomenclature, the value estimate might best be termed as the present value of excess rent for a fixed-term.

Combining the two value estimates represented by partitioning the lease rent into economic rent and surplus rent leads to what may be appropriately described as the value of the leased fee interest of the property, provided the tenant continued to meet all the terms and conditions of the lease, including the obligation to pay the stipulated contract rent.

PROFILE OF SUBJECT PROPERTY

To illustrate the concepts and procedural steps in the valuation of an income-producing property under lease and generating above-market contract rent or excess rent, an industrial property with the following physical and financial characteristics has been chosen:

Year built:	1988
Occupancy:	Single tenant with AAA covenant
Use of premises:	Industrial with ancillary offices
Remaining lease term:	Five years and two months
Fixed annual lease rent:	$269,750 ($6.50/sq. ft.)
Gross floor area (GFA):	41,500 sq. ft.
Office component:	17,845 sq. ft. (43.0%)
Clear ceiling height:	18'
Site area:	143,103 sq. ft. (3.285 acres)
Building-to-land ratio:	29.0%

POTENTIAL ECONOMIC INCOME

To estimate the economic or market rent that the property might be expected to generate, assuming it was vacant and available for lease under terms and conditions similar to those prescribed in the existing lease, a comprehensive review of the existing lease and an analysis of the following comparable industrial rental (lease) data was considered appropriate (TABLE I).

TABLE I
Analysis of Market Leases

No.	Year Built	Premises GFA (s.f.±)	% Office	B:L Ratio	Term	*Average Annual Lease Rate/ Square Foot
1.	c. 1986	20,000	20%	38%	7 years	$4.16
2.	c. 1982	29,980	10%	49%	5 years	$2.46
3.	c. 1989	25,000	20%	40%	5 years	$3.53
4.	c. 1988	24,775	29%	38%	7 years	$4.24
5.	c. 1987	31,600	15%	44%	5 years	$2.92
S.P.	c. 1988	41,500	43%	29%	5.17 years**	$6.50

* After allowance for tenant inducements and free rent periods
** Remaining lease term from date of appraisal

Average annual lease rate range/sq. ft.:	$2.46 to $4.24
Average annual lease rate/sq. ft.:	$3.46
Average lease term:	5.8 years
Average building area:	26,271 sq. ft.
Average building-to-land ratio:	42%
Average office component:	19%

Relying on the market-derived lease information in TABLE I, and taking into consideration the physical characteristics of the subject property, including the terms and conditions of the existing lease, it is believed that if the property was available for lease under similar terms and conditions of the existing lease, excluding the scheduled contract rent, an economic or market rent of $4.25 per square foot could be achieved, fixed for five years and two months, consistent with the remaining lease term as of the date of appraisal. Imputing an economic or market rent of $4.25 per square foot to the 41,500 square foot building indicates potential economic income of $176,375, as shown below:

Gross Floor Area		Unit Rate	Potential Economic Income
41,500 sq. ft.	@	$4.25	$176,375

Vacancy and collection loss

Considering the physical and locational characteristics of the property, the strength of the tenant's covenant, and the supply of industrial space currently available, it has been concluded that an ongoing annual allowance of 5.0 per cent represents an adequate provision against unexpected vacancy and collection loss.

Effective economic income

Potential economic income:	$176,375
Less: vacancy and collection loss (5.0%)	8,819
Effective economic income:	$167,556

Non-recoverable expenses

During any actual or assumed period of vacancy, in addition to the loss of rental income, the landlord becomes responsible for all operating costs, including realty taxes, associated with maintaining unoccupied space. Consistent with the physical characteristics of the property and under the assumption that a residential public mill rate (applicable in the Province of Ontario) would be applied to the assessment of any vacant space in computing the realty tax burden and that only essential utilities would be in operation, operating expenses have been estimated at a rate of $2.75 per square foot of gross floor area. Non-recoverable expenses apply only to space that is either unoccupied or assumed vacant. Corresponding to the projected vacancy allowance of 5.0 per cent, non-recoverable expenses could be expected to amount to $5,706, calculated as follows:

Reported Gross Floor Area		Estimated Expenses Per Sq. Ft. of GFA		Vacancy Allowance		Non-Recoverable Expenses
41,500± sq. ft.	@	$2.75	x	5.0%	=	$5,706

Operating expenses

Given that the projected economic rent would be essentially net to the landlord, the only anticipated expense items would be management and structural repair, which have been imputed as 3.0 per cent and 1.0 per cent of the effective economic income.

Reconstructed Operating Statement

Potential economic income: (41,500 sq. ft. @ $4.25/sq. ft.)			$176,375
Less: Vacancy and collection loss:	(5.0%)		8,819
Effective economic income:			$167,556
Less: Non-recoverable expenses:		$5,706	
Management allowance:	(3.0%)	5,027	
Structural repair allowance:	(1.0%)	1,676	
Total expenses:			12,409
Net economic income:			**$155,147**

Note: The Net Economic Income of $155,147 represents 87.96 per cent of the Potential Economic Income of $176,375.

Capitalization rate analysis

In selecting an appropriate capitalization rate for conversion of the estimated net economic income into an expression of value, before adjusting for the contributory value of the excess rent under the existing lease, a number of industrial real estate investments have been analyzed. Those real estate investments considered most relevant for the purpose of comparison are summarized in TABLE II. Caution should be exercised in the analysis of capitalization rates to ensure that the indicated investment returns are a reflection of economic rents; returns (capitalization rates) that are based on above-market contract rents would likely require a downward adjustment, whereas returns that are based on below-market contract rents would likely require an upward adjustment.

From the date of closing of each transaction, the analysis of the four industrial real estate transactions indicates investment returns ranging from 10.19 per cent to 10.97 per cent based on the average annual lease income expected over the remaining term of each lease, which ranges from 4.08 years to 5.0 years, a time frame reasonably consistent with the remaining lease term of 5.17 years for the subject property. However, the lease income streams assigned to the comparable investment transactions have not been adjusted, as in the case of the subject property, to reflect allowances for vacancy and collection loss, non-recoverable expenses, management and structural repair. As the estimated net economic income of $155,147 represents 87.96 per cent of the potential economic income of $176,375 (based on an economic rent of $4.25 per square foot), for consistency, the capitalization rates indicated by the four sales must be similarly adjusted. Provided the overall capitalization rates are extracted from an analysis of reasonably similar real estate investments, the ratio adjustment process reflecting a similar percentage of net income to lease income represents an effective and easy-to-execute alternative by which to adjust the income stream of each transaction for the individual items of vacancy and collection loss, non-recoverable expenses, management and structural repair. The capitalization rate adjustment process is shown as follows:

Capitalization Rate Adjustment Process

No.	Overall Capitalization Rate	x	Ratio Adjustment	=	Adjusted Overall Capitalization Rate
1.	10.77%		87.96%		9.47%
2.	10.19%		87.96%		8.96%
3.	10.97%		87.96%		9.65%
4.	10.35%		87.96%		9.10%

After executing the one-step adjustment process, the four capitalization rates range from 8.96 per cent to 9.65 per cent, based on the corresponding estimated average annual net income from each comparable property, and the mean and median adjusted rates are 9.30 per cent and 9.29 per cent.

Comparing the returns of the real estate investments analyzed, and given current investor yield expectations, it is believed that an annual rate of return of 9.00 per cent would be the required hurdle rate to attract prospective investor-purchasers to the property, which is occupied by a tenant with a AAA covenant.

Capitalized Value of Net Economic Income

Estimated economic net income:	$155,147
Overall capitalization rate:	9.00%
Capitalized value of economic income stream ($155,147 ÷ 0.09):	$1,723,856

Excess rent

In the example property presented, the tenant enjoys a AAA covenant and there are five years and two months remaining on the lease. Although the lease rate of $6.50 per square foot substantially exceeds the economic or market rate of $4.25 per square foot (assumed fixed for five years and two months, consistent with the remaining term of the lease), indicating a rental surplus of $2.25 per square foot, the lease is in good standing and the tenant has never failed to meet its rental obligations under the terms and conditions of the lease.

Due to the strong covenant of the tenant, prospective investor-purchasers recognize the limited additional risk associated with realizing payment of the excess rent over the remaining term of the lease, and mortgage lenders have indicated their acceptance of including the rental surplus in the calculation of the debt coverage ratio (DCR) and loan amount.

The qualitative rating of the rental surplus supports the conclusion that the entire rental surplus during the remaining lease term should be recognized for its contribution to value with only a slight addition to the risk premium. Accordingly, discounting the excess rent at 10.00 per cent (1.00 per cent above the rate applied to the economic rent) is considered appropriate. (Note: It is appropriate to apply a higher discount rate to surplus rent when it is rated as being less secure than economic or market rent.)

Computation of Excess Rent

Actual lease income (41,500 sq. ft. @ $6.50/sq. ft.):	$269,750
Less: Potential economic lease income (41,500 sq. ft. @ $4.25 sq. ft.):	176,375
Sub-total:	$93,375
Ratio adjustment:	*91.20%
Excess rent ($93,3375 x 0.9120):	$85,158

* The Ratio Adjustment has been increased from 87.96 per cent to 91.20 per cent as the non-recoverable expenses in the initial

TABLE II

No.	Deed Date	GFA (Sq. Ft. ±) (% Office±)	B:L Ratio/ Year Built	Sale Price	Average Annual Lease Income (Rate/Sq. ft.)	Overall Cap Rate
1.	11 months ago	49,063 15%	42% c. 1985	$2,050,000	$220,784 ($4.50)	10.77% (5-yr)
2.	11 months ago	28,215 19%	24% c. 1991	$1,625,000	$165,667 ($5.87)	10.19% (5-yr)
3.	6 months ago	83,174 15%	28% c. 1969	$2,518,000	$276,315 ($3.32)	10.97% (5-yr)
4.	5 months ago	44,013 22%	34% c. 1974	$1,560,000	$161,501 ($3.67)	10.35% (4.08-yr)
S.P.		41,500 43%	29% c. 1988	— —	*$176,375 ($4.25)	— —

* Projected average annual economic lease income over 5.17 years.

analysis of economic income are a function of building size and not potential net income. Excluding non-recoverable expenses of $5,706 increases the net economic income from $155,147 to $160,853 which equals 91.20 per cent of the potential economic income of $176,375.

Present value of excess rent for a fixed term

Annual excess rent:	$85,158
Discount factor @ 10.00% (5 years and 2 months):	3.888641
Present value ($85,158 x 3.888641):	$331,149

Potential overstatement of value

Whenever capitalization in perpetuity is employed as the valuation model for an income-producing property under lease at contract rent which is above-market, there is always the potential of unintentionally overstating the value of the property. Had the excess rent not been identified and dealt with separately as part of a two-step valuation process, capitalization in perpetuity of the actual above-market contract rent would have caused the value of the property to have been overstated. In the example illustrated, the value of the property is overstated by $615,000 or approximately 30.0 per cent ($615,000 ÷ $2,055,000 = 29.9%). Depending on the amount of the excess rent, the anticipated duration of the excess rent, and the rate of discount, the margin of error in the value estimate can vary dramatically.

Capitalized value of excess rent in perpetuity ($85,158 ÷ 0.09):	$946,200
Less: Present value of excess rent for a fixed-term ($85,158 x 3.888641):	331,149
Overstatement of value:	$615,051
Rounded to:	$615,000

Value of leased fee interest

Combined, the individual indications of value pertaining to the economic or market rental component and the excess component of the leased property, achieved by partitioning the contract income into a two-step valuation process, suggest a value indication of $2,055,000 representing the leased fee interest, calculated as follows:

Capitalized value of economic income stream:	$1,723,856
Plus: Present value of excess rent for a fixed-term:	331,149
Indicated value of leased fee interest:	$2,055,005
Rounded to:	$2,055,000

Conclusion

Should a detailed analysis of an income-producing property under lease reveal above-market contract rent, a component known as excess rent must be isolated. Excess rent can be brought about by many factors including declining rent levels during economic cycles characterized by an over supplied real estate market and leasing practices deliberately structured to artificially inflate contract rents to above-market levels. Avoiding the possibility of over valuing a leased income-producing property requires an awareness of prevailing economic or market rents pertaining to the class of real estate being appraised which can only be achieved in conjunction with a thorough review of all property-specific lease documentation, essential to a sound understanding of the terms and conditions of occupancy.

When excess rent has been identified, this rental component must be segregated from that portion of the contract rent that corresponds to the economic rent and undergo a qualitative rating as to its durability and potential contribution to value. In no event should the excess rent be recognized as being sustainable for a length of time that exceeds the remaining term of the lease. Moreover, recognition of excess rent should be afforded only the weight that prospective investor-purchasers would deem appropriate. Whenever a value is assigned to excess rent, the incremental increase in value beyond the value of the fee simple estate implies the existence of a negative leasehold estate which may cause a tenant to seek relief through renegotiation of the lease on more favourable terms and conditions or termination of the lease, possibly by way of a cash payment.

The rental income generated under contract from a lease that exhibits above-market rent must be partitioned to accommodate a two-step valuation process that distinguishes between capitalization of economic or market rent (assumed to be sustainable indefinitely) in perpetuity and discounting of excess rent (only temporarily sustainable) for a fixed term not to exceed the remaining term of the lease. Employing capitalization in perpetuity as the valuation model for conversion of excess rent into an expression of value would have the effect of recognizing fixed-term income as being as indefinitely sustainable as economic or market rent and would overstate the contribution of excess rent to value.

A value estimate of a leased-property which fails to recognize excess rent by replacing above-market contract rent with economic rent, while continuing to acknowledge all other terms and conditions of the lease, might best be viewed as an opinion of the market value of the leased fee interest with economic or market rent imputed rather than as an opinion of the market value of a fee simple estate, which denotes absolute ownership of property unencumbered by a leasehold (lessee's) interest or by any other interest.

The two-step valuation procedure articulated and illustrated has been presented as one possible solution to effectively deal with leased properties that generate excess rent and the application of the two-step valuation model appears to be best suited to the appraisal and analysis of income-producing properties that are under lease to a single tenant. ▲

Endnotes

1. Definitions interpreted from *The Dictionary of Real Estate Appraisal, Second Edition*, published by the American Institute of Real Estate Appraisers; *The Appraisal of Real Estate, 10th Edition*, published by the Appraisal Institute; and *Income Property Appraisal and Analysis*, by Jack P. Friedman & Nicholas Ordway, published by the American Society of Appraisers.