

Understanding Effective Rent

When tenants decide to start searching for potential office leasing alternatives in today's market, creating a system for comparing the value of the various choices can be a daunting task. For instance; how important is it to your company to be near public transportation? The answer to that question depends on which company you are asking, and can even depend on what department you are asking. The CFO may like a less costly property further away from either BART or the Ferry building due to his or her concern for the bottom line. The Human Resources Department may find it more difficult to hire good people if you are asking those new employees to increase their commute.

"Rent" is a wonderful source of confusion when taking on a value comparison because rental rates come in many different forms. Leases in San Francisco are complex, and can be as long as 70 pages. Within these documents, there are multiple items that have an effect on how many real dollars were spent, or saved, on office space occupancy over time.

The best way to view rent is to separate it into two categories; "Face Rate", and "Effective Rent". Face Rate is essentially the amount of money listed as rental payments within the lease document. This is usually very clear, and is sometimes referred to as base rent. If a tenant signs a lease, and within that lease it says they will pay \$40 per rentable square foot, per year (\$40 rsf), this is the Face Rate of the lease. It captures the rental cost at an exact moment, ignoring past and future increases, reductions, or concessions.

Face Rate ignores, however, items listed in the lease document that can impact payments over time. The two most common items are abated rent at the beginning of the lease term, and normal percentage increases in rent over the entire lease term. When you take into account these other items, you create a more accurate assessment of the value of the lease; "Effective Rent." Effective Rent gives a dollar value per foot based on the entire life of the lease, taking into consideration all of the changes that occur to payments over time.

How does the math work? Let's say an office tenant signs a lease for a five-year term, for 10,000 square feet, and the lease states the tenant will write a rent check every month over five years in the amount of \$33,333.33 per month, with no abated rent. It is easy to compute both the Face Rate and the Effective Rent in this situation, because they are the same; \$40 per square foot per year (\$33,333.33 multiplied by 12 months divided by 10,000 sqft equals \$40).

However, what if the lease states rent will be increasing by \$1 per square foot per year over five years? What impact will that have on the value of "rent?" The answer is that it will not change the tenant's current Face Rate, because the tenant is still writing a real check for the real dollar amount of \$33,333.33 every month this year. The change is to Effective Rent, because it considers time and change. Under this system, the Face Rate is still \$40 per square foot per year now, but in the fifth year of the lease, Face Rate will have built up to \$44 per square foot per year. Therefore, the Effective Rent value of this lease is \$42 per square foot per year (\$40 year one, \$41 year two, \$42 year three, \$43 year four, \$44 year five, divided by five years of term equals \$42 effective).

What if the landlord, as part of the lease negotiations, abates the rental payments for the first year as a concession to entice the tenant into the property, but leaves everything else the same? This will drive the Effective Rent down. By removing a years worth of rent, the total value of the lease decreases dramatically to \$34 per square foot per year (\$0 year one, \$41 year two, \$42 year three, \$43 year four, \$44 year five, divided by five years of term equals \$34 effective), while the Face Rate for years two through five remain unchanged. Although this is a larger than normal abatement for this hypothetical tenant and lease term, abated rent is a normal concession, and can have a dramatic effect on all parties involved.

What else can impacts Effective Rent? It depends largely on who is doing the analysis, but a major component of lease documents that some consider and some ignore when calculating Effective Rent is the tenant improvement dollars provided by the landlord to the tenant. This dollar value is real, and when calculating Effective Rent, you spread the value out over the life of the lease to end up with Effective Rent including tenant improvements.



Real value in a changing world

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It is important to remember, the purpose of knowing Effective Rent in the first place is to create a tool that we can use to compare various properties we may be considering moving into. With this in mind, is it fair to enter into this equation tenant improvement dollars? Certainly one landlord will offer more than another, but it may cost more in the first building to complete the buildout and therefore the value increase to your company is mitigated. This is true for cabling costs, moving costs (a renewal for instance), and any other factor that is not so easily spelled out in the lease itself.

Why is this information important? Different parties use these numbers for different purposes. Here are two examples; In one case, we represented a tenant and successfully negotiated a lease on its behalf that consisted of a lower than normal lease rate, but no abated rent due to time constraints. At the last moment, the landlord requested we change the economic dealpoints to include a higher Face Rate, but with three months of abated rent during the first year of the lease.

The landlord's offer to change was based on future building values, and did not alter our lease value because the Effective Rent was the same. Our client did not care either way because they understood the math behind the numbers. The reason for the change on the landlord's side was to create an illusion that, based on Face Rate, tenants were willing to pay a higher amount to be in his property than they would to be in a neighboring property. It also increased the investment value of his property once we were past the abated rent period, because a potential buyer of the building would see higher rents during their ownership period.

In a second example, we represented a tenant that had to grow their space occupancy dramatically, but had three years remaining on their current lease. We negotiated a lease for new space in a different building, but in a building owned by the same investment group that owned the property the tenant was vacating. Part of the negotiation was that the tenant would agree to pay an above market face rental rate in the new space, if the landlord agreed to terminate their lease in their previous space. This strategy worked great for all parties. The tenant did not have to take responsibility for trying to sublease their old space, and the landlord got both a higher Face Rate for the new lease, and they were able to keep the tenant in at least one of their properties instead of losing them entirely.

Is it fair to include in the tenant's Effective Rent the additional Face Rate paid at the new property, or the savings acquired via a lease termination at their old address? Again, it depends on the calculations. Effective Rent is a tool, designed to be used with lots of other pieces of information, and different companies place value on different items.



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