FINANCIAL ADVISORY

When Reviewing Properties, Sometimes that Lease "Positive" is Really a Negative

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COULD THAT POSITIVE BE A NEGATIVE?

Over my years in the real estate business, I have seen properties marketed many different ways. I've seen more than a few marketed in surprising ways. Perhaps the strangest examples involve properties marketed with a negative characteristic described as a positive one. This article will review a couple of "negative sold as positive" examples that I commonly see. After you've read it; you will be able to identify these situations while evaluating potential acquisitions. More importantly – you'll learn what extra research is necessary in these cases.

"TENANT HAS SEVEN 5-YEAR OPTIONS TO RENEW THEIR LEASE"

Representing options to renew as a benefit rather than as a liability is probably the worst offender out there. Giving a tenant an option to renew is essentially handing them a call option. When the tenant's lease comes due they will pay the LOWER of market rent or the option price.

Let's walk through a quick example: Say that you own a small shopping center, and have a Hallmark franchisee as a tenant. The store pays $25 per square foot, per year for a 2,500 square foot space, and has one 5-year extension option at $27.50 psf/yr. When Hallmark's current term expires, your tenant will look at the market. If the market rent in the area is $35 psf/yr; they'll happily exercise that option to renew at a sizable discount. If, on the other hand, the market rent is $25 per year (or lower), Hallmark will not use that option and will instead re-negotiate the lease with you. So to summarize: an option to renew can ONLY be beneficial to a tenant – and that means it can only be detrimental to a landlord.

This does not mean that you should avoid tenants with options. Signing a great national-name tenant will usually require granting an option to renew. This isn't, however, a "great attribute" of your property – especially if it's one of those famous "no rent increases for 75 years" string of options favored by

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tenants like Walgreens.

"BELOW MARKET RENT TENANTS."

This seems to be a favorite claim among listing brokers because it can create opportunity in the minds of potential buyers. A buyer may think; "I can buy this property and raise rents immediately – for instant return!" This phrase, however, could mean several things – and many of them aren't good. Some possibilities are:

1. It is not true. Do your homework: look at the surrounding market and determine what you think is the market rent. Is the rent indeed below market? The chances are pretty good that it isn't. After all, since investment properties are valued and sold based on a multiple of income, wouldn't an owner want the maximum income possible if he was selling his building? Wouldn't that listing broker advise his client of the same? If the seller isn't truthful about this element of the property, what else could he be hiding?

2. It is true – and there's a reason for that. Below-market-average rents may indicate a below-market-average property. Is the property older than competitive properties? Does it have a lot of deferred maintenance? Is it missing key features such as covered parking or air conditioning? Be careful – you could end up working harder than average to find tenants paying you less money.

3. It is true. Many landlords, myself included, prefer to keep rents a little bit below the market average. By doing so; we can be more selective about our tenants – and only pick the best applicants. Additionally; our good tenants, once chosen, tend to stay with us for longer knowing a comparable property across town will only cost more money. As a new owner, you'll want to be careful about raising rents. The tenants may already be nervous about new ownership – an immediate rise in rents could send them packing. The last thing you want is to pay "stabilized" prices – and end up owning a property with vacancy problems.

Five years ago, buying a property with "below market rents" could be an opportunity to buy and raise rents substantially. Today, however, rent control is the "law of the land" here in California. A property with rents that haven't kept up with the market could take a long time to catch up again.

When reviewing potential real estate acquisitions, the presence of either characteristic discussed above is not necessarily a "deal killer;" (an absolute reason that you should walk away from a deal.) Rather, the presence of these characteristics can be an indication that you need to dig a little bit deeper as part of your due diligence process.

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