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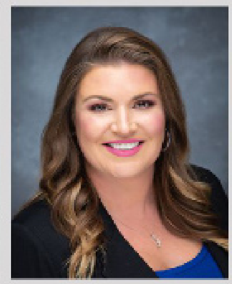

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FEBRUARY 2023

The Cancellation Clause In A Commercial Lease

Whether a rental market is weak or strong, lease negotiations can be difficult when the landlord wants concessions that are different from the norm.

One situation that happens is when the owner of an office building or other commercial property intends to sell when market conditions improve, whether that occurs next year or five years from now. Another is the holder of vacant or underimproved property who plans to develop it whenever market conditions justify. In the meantime, these properties must be leased to generate sufficient cash flow to pay operating costs and debt service. Such an owner will be amenable to giving significant concessions, including a low rental, provided the landlord can cancel the lease during the term.

An alternative to a long-term lease subject to cancellation is a series of short-term leases. However, a long term lease subject to cancellation under specific conditions may be much more preferable to a tenant than a short-term lease that the landlord can refuse to renew for any reason. Here are some guidelines for drafting a fair cancellation clause.

The Guidelines

The option to cancel the lease by the landlord could easily lead to misunderstandings and lawsuits unless it is carefully drafted. Here are some important things to consider:

• **Definite Reason.** A landlord asking for the option to cancel in order to sell the property or demolish the improvements nevertheless may want the option clause in the lease to be unconditional. The need to specify a reason in the notice exercising the option could raise questions of good faith or improper exercise if, for example, a subsequent sale or demolition is delayed or postponed for a period. On the other hand, the tenant may insist that a reason be given; oral representation during negotiations will not themselves limit a cancellation option that is unconditional in the lease.

• **How the option is exercised.** One solution to the problem of an unconditional option is to make it exercisable only on actual sale of the premises. This would mean that possession could not be given at the closing of title and so be unacceptable to the buyer. The landlord will want the option exercisable at the time the contract is signed (perhaps with the tenant to be entitled to remain until title is closed).

• **Notice to tenant.** The tenant will need a reasonable time to terminate its business and remove its property. The landlord will not want the notice period to be so long as to discourage a prospective buyer.

• **Reimbursement to tenant.** If the tenant will incur substantial costs to prepare or improve the premises for use, it may insist on reimbursement if the lease is canceled. A common formula is to amortize the up-front costs over the lease term, with reimbursement to equal the unamortized cost at the time of cancellation. (An alternative method is for the rent to be set initially at a low level, stepping up after periodic intervals.)

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The lease should make clear when any such payment is to be made–at the time the notice of cancellation is given, at the time the tenant vacates, or at a subsequent time. Use of an escrow may be a solution to this issue.

- **The new landlord.** Suppose the original landlord sells the property to a buyer willing to take the property subject to the existing lease so no cancellation occurs. Does the new owner have the right of cancellation, or does it terminate on the sale? This should be made clear; if the option extends to the new landlord, it should also be clear as to whether the original or successor landlord is responsible for any payment due the tenant.

- **Right of first refusal.** The tenant may seek a right of first refusal in the event of a proposed sale accompanied by a cancellation of the lease. This would give the tenant the right to match the offer of a third party to buy the property. Landlords do not like rights of first refusal because they complicate efforts to sell; in this situation, it is unlikely that the tenant will insist on the right since the value of the property to a third party intending to develop it is likely to be substantially above the market value of the property under its current use.

- **Tenant's right to cancel.** The tenant may ask for a similar right to cancel the lease under certain conditions. While the landlord's cancellation option is fully valid without a corresponding right for the tenant, the landlord may be willing to make this concession in order to gain agreement. ❑

Building On Leased Land

Building on leased land results in a separate ownership of that building and the land. The two owners, one of the land, and one the improvement, come together in one investment parcel. In this situation, the landowner wants someone to develop the land, but still wants to continue in ownership. The developer prefers to lease rather than buy the property.

One owner wants the security of owning the land with a good lease to the owner of the improvement. The owner of the building puts up less money since the ownership of land is not part of the expenses in the development.

Benefits To The Lessor

An example could be the developer of upscale homes who wants to keep the ownership of the land as an investment. The use of the land lease can widen his market by reducing the purchase price of the house. In certain parts of the country, the value of the land equals or surpasses the value of the house. Leasing the land can cut the purchase price nearly in half. With this type of land lease, there is usually a provision for a rent increase halfway through the lease term in accordance with the results of a reappraisal of the land.

Benefits To The Lessee

The land lease results in the following benefits for a builder or developer:

- He/she can acquire a valuable parcel of land with very little cash investment.

- This leasehold that is acquired is an asset that can increase in value, and then could be used as security for a loan, or could be sold for a profit.

- The rental payments are fully deductible by the lessee.

- With a subordinated land lease, the lessee-developer gets the equivalent of a 100% loan on the land.

The Term of the Lease

Usually, a developer/lessee will attempt to get the longest possible term in the lease because the shorter-term land lease would have a smaller market for resale. A long-term land lease is generally a net lease under which the lessee pays the carrying costs, including real estate taxes.

When the land rental is a fixed amount, it is a percentage of the fair market value of the land when the lease is executed. This lease will often include a provision for reappraisal of the land at fixed intervals, with new adjustments in the rent. In some cases, for instance with a shopping center, the landowner might demand a share of the percentage rentals over and above the fixed land rent. (Much of the income in the shopping center will come from percentage overages from the sub-lessees.)

Subordination Of The Lease

If the owner of the land will not subordinate the lease to a leasehold mortgage, the developer should get a reduction in rent because the unsubordination will cause his financing to be more expensive. Subordination could be the most important item in the terms of the lease. Even a short subordinated lease might be better than a longer unsubordinated lease, even though the longer lease is more salable.

The landowner may or may not allow his interest as owner/lessor to be subordinated to the interest of a leasehold mortgagee. When there is a subordination to the mortgage, the lender, in effect, gets a fee mortgage on the land rather than a leasehold mortgage.

When the lease is unsubordinated, the landowner/lessor has first rights over the lender in case the lessee-mortgagor should default. With these terms, the lessee could find that he cannot get a loan, or can get one only at a higher rate of interest. Without the subordination, the

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When ideas in tax and other legal areas seem to fit your situation, it is recommended that you discuss them with your professional advisor before taking action.
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mortgage is, in effect, a second lien since the lessor's claim on the rents takes precedence over payments on the mortgage.

The objections of an owner to subordination of the lease could be as follows:

- He could lose the property if the lessee defaults on the leasehold mortgage.
- Subordination reduces his possibility of mortgaging his fee interest in the land, which would be a logical move for the lessor.

If the subordination were part of the terms, the landowner would record his right to receive any notice of default from the leasehold mortgagee and the right to cure the default. The expense would be reimbursed to the owner by adding the amount to the lessee's rent obligation. ❑

Adding Value Means Increased Cash Flow

Since the value of a rental property is based directly on the cash return, adding value means increasing cash flow.

When small investors set out to increase real estate values, the steps are in upgrading houses, duplexes, triplexes, etc., enhancing the cash flow and therefore increasing equity when the property is sold.

When working with larger commercial and apartment properties, there are two major actions:

- Be aware of the things that have the potential of adding value, taking advantage of this knowledge and moving quickly before another buyer can purchase or option the property.
- Do the required homework on the property. A feasibility analysis can measure the ability to add value. There may be many other measures that must be taken, such as market analyses, applications for new zoning, design and construction planning and a plan for marketing.

Making Money

Investors purchase commercial income producing real estate to make money. There are two obvious ways of making money from a property.

First, the owner takes a share of the annual operating profit generated by the investment, and

Second, profits from increasing the market value of the investment beyond what it would be because of inflation alone.

Apartment properties lend themselves to the second way of making profits better than many other types of investments. Increasing the market value of rental units does require know-how, absolute understanding of the market values of this type of property and excellent management.

The Operating Income

Good management has always been the most important point in increasing or maintaining annual operating profits. Being a skillful manager requires intelligent handling of the functions of buying and selling properties, rent collections, maintenance, leasing, controlling expenses, refurbishing, management accounting and more. All of this requires long "hands-on" experience in the field with plenty of assistance from the latest in operational and administrative hardware and software. Professional property managers will do a much better job than most owners and will more than cover their fees. ❑

Pre-Leasing For Construction Loans

Whether it's a new office building, industrial warehouse, retail shopping center, or high-rise residential apartment building, investors and lenders increasingly demand to see a substantial portion pre-leased before they are willing to put up construction money. Purely speculative construction projects are rare in today's real estate market.

People are reluctant to invest in buildings that do not have good strong prospects for leasing. The old days when developers and investors would go in and spec a building really are rare. Now developers and investors expect to have a tenant going in and taking away some of the risk. The trend away from speculative building without pre-leasing is having a profound impact.

Build-To-Suit Projects

The decline (and in some sections of the U.S., the demise) of speculative building is being replaced by an increase (and in some sections of the U.S., a surge) in build-to-suit projects. That's because build-to-suit is a process in which the owner (or main tenant) is going to get exactly what he needs in the most expeditious manner. One design/build firm said "Built-to-suit has become more popular because of its cost-effectiveness and in giving exactly what the client needs and wants". ❑

Property Management Increases Value

Management of a building is not just handling problems as they arise and renting units, it is making the asset more valuable to the owner by concentrating on every aspect of the property. Some owners of very large income properties still do not take professional property management seriously and fall behind in values.

The professional property manager is keenly aware of all of the recurring costs of a property and how they can effect the bottom line. The owner may applaud and give attention to a one-time saving on a "high-cost" item such as insurance on the property while overlooking the multipliers in the number of units.

For example, a $6,000 reduction on that annual insurance premium is a big item. However, it is only a $6,000 item once a year. A change of $10 per month per unit in a 400-unit apartment, either in rent increase or expense savings, can add $4,000 a month to income, or $48,000 a year. This small $10 per month could add $600,000 in value to the property in a sale ($48,000 increase in rents divided by 8% capitalization rate). Using the same capitalization rate, the $6,000 savings in cost of insurance would only increase the value by $75,000.

The Down Side

The manager must also be aware of the multiplier effect in downward changes in income and the possibility of changing a marginally profitable property into an investment loss. For instance, a seeming insignificant increase in the price of janitorial service in a 250,000 square foot office park could significantly decrease the cash flow and adversely effect the resale value by hundreds of thousands of dollars.

The larger the property, whether in square footage or number of rental units, the greater the significance of the multiplier effect.

Strategies should be defined and stated in a management plan developed by the owner and the management company.

Another important goal of property management is to ensure that tenants live, work, shop, and play in a safe and clean environment and have their real estate-related problems attended to promptly. ❑

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