White Paper
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A SLOW JOURNEY TO TRUTH IN NER LEASE PRICING AND ITS IMPACT ON THE COMMERCIAL PROPERTY MARKETS

How archaic methodologies have stalled economic progress in lease pricing

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Executive Summary

In this white paper, we explore the historic and current methodologies in commercial property lease pricing, and why "rule of thumb" methods adopted in the past have been slow to adjust and adapt to today's current market conditions.

We will begin with a historical observation of one of the first publications to examine the methodology of what is now considered "Net Effective Rent" published in July 1986 by the National Council of Real Estate Investment Fiduciaries or NCREIF. Within this publication, we examine the "effective rent" methodology, and will consider and contemplate why the time-value-of-money was omitted. We will examine the historical contexts at the time of this publication to better understand why the time-value-of money may have been excluded, including the pricing of assets, the relevancy of computer added tools, and the efficiency and sophistication of commercial property markets.

In concluding, we will examine the modern methodology of "Net Effective Rent" outlined within the REALPAC/ AIC Terminology Standards with detailed discussions and calculations. It is within this publication, that the simple inclusion of what most commercial property investors would consider sacrosanct, is finally considered in the pricing of commercial leases; that is time-value-of money, or TVM.

Lease Pricing and TVM

As Albert Einstein said "The measure of intelligence is the ability to change," so what is it that makes our commercial property markets so slow to adapt, especially when it comes to leasing? It seems strange to consider that commercial property investors have priced assets using the time-value-of-money for as long as spreadsheets have been in existence; however, most leasing professionals today are still utilizing non-TVM pricing methods that pre-date 1986. What is even more of a paradox is; if each property is valued as a collection of leases where TVM equations are utilized, then why are individual leases that are components of this property, negotiated and/or priced assuming no TVM is considered? The standard answer, "we do that once we get to the final proposal process"; however, 2-weeks have passed where imprecise and inaccurate information has engaged both landlord and tenant on LOI terms incompatible to both. Is this a measure of intelligence?

Net Effective Rent (NER) Lease Pricing Circa 1986

In July 1986, the National Council of Real Estate Investment Fiduciaries or NCREIF published what can be considered one of the first technical documents describing what is now called "Net Effective Rent".

Figure 1

Effective Rent Calculation

In calculating the Effective Rent of a tenant, all cash inflows and outflows must be calculated for the term of the lease. The result, divided by the term and further by the square footage, is the true or **Effective Rent** level for that tenant.

Using a simple example, assume a tenant signs a five (5) year lease for 10,000 square feet, at a contract rent of $18.00 per square foot per year. The terms of the lease provide for the tenant to reimburse all operating expenses in excess of $4.00 per square foot (which in this example is the current expense level for that building) to the landlord from the occupancy date. The tenant is given a nine (9) month free rent period, and provided with a $50,000 tenant improvement allowance in excess of the standard.

The net **Contract Rent** is $18.00 (rents) less $4.00 (operating expense base), or $14.00 per square foot.

The net **Effective Rent** is calculated as follows:

Rental Income Per Month	$ 15,000
Number of Months Paying Rent	x 51
Total Compensation to Landlord	765,000
Less Landlord Excess Contribution - Over-Standard Tenant Allowance (the amount attributed to other concessions, if any, would be deducted here)	50,000
Net Compensation	$ 715,000
Per Square Foot, Per Year ($715,000 - 10,000 s.f., further divided by 5 years)	$ 14.30
Less Expense "Stop"	4.00
Effective Rent	$ 10.30

The disparity between **Contract Rent** and **Effective Rent** is $3.70 per square foot per year. In general, Effective Rents will approximate Market Rents if the lease was freely negotiated between a willing lessor and lessee in an open market free of tenant or landlord-imposed constraints. The situation above should indicate to a wary investor that Market Rents may be below Contract Rents.

As displayed in Figure 1, albeit from the tenant rather than landlord perspective, the simple calculation reveals what started as a rule-of-thumb calculation in 1986, has become the deficient analog for pricing leases even in the current environment. What is excluded from the methodology is the time-value-of-money or TVM. It's somewhat puzzling that while property pricing has assumed time-value-of-money since its inception, that lease pricing and leasing practitioners have never changed.

Part of the adoption and prevalence no doubt fell on the fact that during that period CAP Rates were so elevated (almost 400 basis points greater than today), that rule-of-thumb methods excluding TVM were satisfactory estimates given the margins for error; margins easily forgiven by rates of return exceeding 10.0%. Additionally, leasing professionals at the time had limited access to computing power (the year IBM introduced its first Desktop PC), let alone a suite of technology tools that could provide precision financial decisions with minimal effort.

Now, fast-forward 30 years and ask "what is our measure of intelligence" today? Unfortunately, for commercial property investors not much has changed, the same 1986 methodologies continue to permeate the market and thereby misprice leases with broad negative financial implications. From our estimates, for every $10.00 adjustment in leasing capital, property owners are negotiating $0.55 less per square foot in annual rent; a shortfall of roughly $5.5M in rent for every 1M square feet over 10 years (See table page 5).

NER Modern Standards in Lease Pricing

Through education and awareness in recent years, an intelligent way forward in lease pricing begins to emerge, one that promotes a modern "Effective Rent" or NER methodology. With contributions from significant stake-holders including National Association of Industrial and Office Properties (NAIOP), Institute of Real Estate Management (IREM), Building Owners and Managers Association (BOMA), and Real Property Association of Canada (REALpac), we begin to see the necessary change that was required to address the sophistication in the commercial property markets almost 30 years later; that is the time-value-of-money in lease pricing. The first non-academic trade group publication to provide detailed discussions and calculations on lease pricing was Canada's REALpac. In their opening discussion they describe why a modern standards for "Net Effective Rent" or (NER) must be adopted; primarily to properly measure and describe rents which have become inconsistent between stakeholders such as owners, building managers, investors, brokers, financial analysts, and government. In REALpac's own assessment "The resulting confusion has led to uncertainty and a lack of confidence, thus motivating a need to provide an improved and effective method of measuring an 'effective' rent." The REALpac committee further defines Net Effective Rent ("NER") to provide "consistency and certainty within the Industry with respect to the measurement of 'effective' rent". It is their assessment that management use this modern standard of "Net Effective Rent" or NER for the purposes of performance measurement and decision-making surrounding lease approval. Other investment stakeholders such as analyst and brokers advising landlords would also utilize the modern

Effective Rental Rate, SOURCE: NAIOP [1], IREM [3]

"Generally, the effective rental rate is the equivalent constant rent per period that equals the present value of the net cash flows over the lease term. "

Net Effective Rent (NER) , SOURCE: REALpac [2]

"Modern standards for Net Effective Rent or (NER) must be adopted; primarily to properly measure and describe rents which have become inconsistent between stakeholders"

standard of NER to properly price leases for landlord clients. The diagram below summarizes the modern standard for pricing leases using Net Effective Rent (NER) as adopted by the REALpac committee of institutional property owners (for further detail on the recommended methodology please see publication).

Net Effective Rent (NER) Modern Terminology Standards

Method of Calculation (for Pricing Commercial Property Leases) SOURCE: REALpac, AIC

The NER measurement seeks to establish the true present value of all cash or near cash inflows and outflows for a given lease deal. NER is generally calculated as follows:

1. Prepare a cash flow forecast showing Rent payable and deal expenses (i.e. capital incentives) payable under the proposed lease deal covering the fixed lease term (excluding optional renewals) broken out by month, quarter or year, as the case may be
2. Discount the Rent to a present value using an annual discount rate, or the monthly or quarterly equivalent
3. Deduct the present value of lease deal expenses, such as tenant inducements and leasing commissions, from that present value of the future Rent calculated in step 2
4. Deduct the value of any Free Rent periods from the present value of the future Rent calculated in step 2
5. Amortize the remaining present value in even amounts over the duration of the fixed lease term, excluding the term of optional renewals. Generally, an annual per square foot rental rate is the desired resulting value for NER

The Economics of Change

As acknowledged by the Real Property Association of Canada (REALpac), NAIOP, IREM, and BOMA, the Industry must take significant steps forward towards a standardized methodology whose consistency and precision will achieve greater credibility among stakeholders. The prevalent inconsistency in use and definition of terms in Net Effective Rent (NER) has created complications for market participants in analyzing and comparing lease transactions; and has been generally prohibitive to increasing transactional efficiencies and market velocity in the leasing of space.

The times of simple straight-line NER estimates have long passed, and now some 30 years later, led by sophisticated investors like Brookfield Asset Management, do we begin to see the slow journey to truth in lease pricing. A journey from 4th grade math, and a simple lease average, to college level finance, and a Net Effective Rent (NER) inclusive of TVM, utilizing optimization.

NER Economic Impact to Property Investors (Utilizing Circa 1986 Lease Pricing Methodology)			
	(For every dollar adjustment in leasing capital)		
	$10.00	$20.00	$30.00
Rent Shortfall (Annual PSF)	($0.55)	($1.10)	($1.66)
Rent Shortfall Per 1M SF (Annual)	($551,863)	($1,103,726)	($1,655,589)
Rent Shortfall Per 1M SF (10-year Horizon)	($5,518,629)	($11,037,259)	($16,555,888)

References

1. NAIOP Terms & Definitions: U.S. Office and Industrial Market, National Association for Industrial and Office Parks ("NAIOP"), 2005, p. 18.
2. Terminology Standards with Detailed Discussions and Calculations, Real Property Association of Canada ("REALpac")/Appraisal Institute of Canada ("AIC"), Draft Final, August 1, 2001.
3. ASM-604-Commercial Real Estate Financing and Valuation, Part Two, Institute of Real Estate Management ("IREM") 010201R-ASM604/LES6, 2001.
4. Lease Analysis, Valuation, Negotiation and Approval, Building Owners & Managers Association ("BOMA"), 2013.
5. Calculating "Effective" Rental Rates in Analyzing Proposed Real Estate Acquisitions, National Council Real Estate Investment Fiduciaries ("NCREIF"), July 1986, p. 4.

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