Real Estate Review

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- STANGER SYNDICATION SALES DATA
- **REAL ESTATE DEALING, *Paul Zane Pilzer***
- SYNDICATION TOPICS, *David A. Smith*
- PEOPLE AND PROPERTY, *Emanuel B. Halper*
- LEGAL OPINION, *Richard Harris*
- CORPORATE REAL ESTATE, *Robert B. Hulley*
- OPTIMAL STRUCTURING OF THE NONFINANCIAL SALE-LEASEBACK, *Michael J. Little*
- THE STING: THE LOAN MODIFICATION THAT A LENDER CANNOT REFUSE, *William C. Handorf and Michael P. McCarthy*
- EVALUATING THE EFFECT OF DEVELOPMENT COST CHANGES, *Richard B. Peiser*
- "DEVELOPING" AN INTUITIVE UNDERSTANDING OF THE IRR, *W. Tod McGrath*
- GAP FINANCING: AN OPPORTUNITY FOR VENTURESOME THRIFT INSTITUTIONS, *N. Christopher Cheatham*
- ARE S&L PARTICIPATIONS IN REAL ESTATE VENTURES TOO RISKY? *John Crockett, Clifford Fry, and Paul Horvitz*
- CREATIVE FINANCING EXPOSES LENDERS TO DEVELOPERS' LIABILITIES, *Robin Paul Malloy*
- DURATION: A POWERFUL NEW TOOL FOR MANAGING INTEREST RATE RISK, *Charles H. Wurtzebach and Neil G. Waller*
- A REVOLUTIONARY STRUCTURE FOR OWNERSHIP, *Sam W. Galowitz*
- AN INTERVIEW WITH AN AVERAGE SUPER-BUILDER, *Stephen P. Jarchow*
- ESTIMATING RETAIL SALES POTENTIAL FOR A PROPOSED REGIONAL SHOPPING CENTER, *W.B. Martin*
- A RISK SIMULATION APPROACH TO LONG-RANGE OFFICE DEMAND FORECASTING, *Joseph J. Del Casino*
- COMPENSATION GUIDELINES FOR MORTGAGE UNDERWRITERS AND ANALYSTS, *Paul J. Lewis and Jerry Hurley*
- EXPLODING SOME MYTHS ABOUT HOUSING FOR THE ELDERLY, *Kathy Carroll and V. Katherine Gray*

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Real Estate Dealing

PAUL ZANE PILZER

A BELOW-MARKET LEASE BUYOUT "CREATES" VALUE

The value of commercial property is usually some capitalization of its net operating income. Because this valuation method is so generally used, a real estate entrepreneur can "create" value by purchasing property that is subject to a long-term below-market lease and buying the tenant out of his "equity" (low lease rate) position. He creates value because the price that he pays the tenant values the lease position for a finite period of years, while the financial markets value the new higher lease rate into perpetuity.

Why does the opportunity exist, and why haven't others or the present owner taken advantage of this opportunity? Because typical real estate purchasers or lenders usually require an absolute minimum going-in yield or financial coverage ratio, and the initial low yield of the property makes the deal unworkable for them.

Properties that have this potential for value creation are easily identified by their relatively low asking price per square foot. A property encumbered by a fixed low-rate long-term lease is usually on the market at far below its true discounted value inclusive of the below-market lease encumbrance. And even that asking price may be negotiable.

WHY ENCUMBERED PROPERTIES ARE UNDERVALUED

The opportunities arising from these kinds of undervalued properties exist because most of the parties seeking to purchase first-class commercial income-producing property are structured financial institutions. Financial institutions often operate with an absolute minimum cash-on-cash yield requirement. Although the institution's "dealmaker" may realize that a certain low-yield property is the best buy available, the financial institution may be limited by the following constraints:

- It may have already committed itself to third-party fund participants to purchase only properties that offer a specific minimum going-in return.
- It may be subject to the supervision of a regulatory body (state insurance commissioner, FDIC, FHLBB, etc.) that frowns on negative amortization or low current-yield investments.
- It may be a publicly traded entity that is sensitive to its stock price and whose accounting methodology does not allow it to account for low initial yield investments accurately.

Individuals who purchase first-class income-producing property usually require financing from these same financial institutions. These financial institutions in their roles as lenders also require strict cash flow coverage ratios when they underwrite loans; and they raise their eyebrows at exceptions. Thus, these institutions do not consider properties that offer current yields that are below the conventional thresholds either for acquisition or for financing. Because institutional practice reduces both potential purchasers and lenders (i.e., reduces demand), these properties trade at lower prices than those implied by their actual discounted cash flows.

Opportunities in these undervalued properties also exist because of either ignorance or negligence on the part of the tenant and the landlord. Tenants are usually too preoccupied with the operation of their principal businesses to focus on the significant profit opportunities created by below-market leases. Moreover, the larger the corporation in which the tenant functions, the further removed is the tenant's operation from the corporate financial department that would understand (and book) the gain. Similarly, the developer/landlord is often too preoccupied with leasing new and vacant spaces to focus on renegotiating existing leases. And the finance department of the institutional landlord is often too far removed from the real estate itself to notice the opportunity.

AN ILLUSTRATION OF VALUE CREATION

Assume there exists a 100,000 square foot commercial property in a market in which properties of this type rent for $10 per square foot (triple net). Properties of this type are normally worth ten times (10 percent capitalization rate) net operating income (NOI). Since the

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market rent for this building is $1 million, the building, if it received market rents, would be worth $10 million. This property is encumbered by a triple net lease that pays $6 per square foot (yielding net operating income of $600,000) with a remaining term of five years. The owner offers it for sale for $7.5 million; that is, he has capitalized annual income at 8 percent.

At first glance, the asking price (based on an 8 percent cap rate) seems high, but in actuality it is $1 million too low. This property, encumbered as it is, is worth $8.5 million (a 7 percent capitalization of its NOI), provided that the tenant would agree to a simple deal that is highly favorable to the tenant. The tenant would allow its lease rent to be increased to the market rent in exchange for the value of its equity interest in the low-rent lease. That equity interest is the present value at 12 percent of the tenant's $400,000 per annum below-market rent for five years. It amounts to $1.5 million.

A perspicacious entrepreneur purchases the property for the asking price ($7.5 million) and pays the tenant the $1.5 million so that the purchaser may increase the tenant's rent to the market level of $1 million a year ($10 per square foot). The real estate entrepreneur, having purchased the property for $9 million ($7.5 million asking price plus $1.5 million lease buy-up), now possesses property valued at $10 million, a value creation of $1 million.

Note that most of the tax and accounting rules governing such a lease buy-up make the transaction attractive to the tenant and are neutral for the landlord. Assuming the lease was a long-term (i.e., capital) lease for the tenant, the $1.5 million payment that it receives is taxed at capital gains tax rates, but its increased rent is deducted as ordinary income (rent) over the five-year period. The landlord's $1.5 million payment is tax neutral for him because it is amortized over the five-year period during which he receives the (taxable) higher lease rent.

The lease buy-up presents the new owner (or indeed the current owner if he is alert to the opportunity) with a chance for a 200 percent immediate return on capital. If the owner can refinance the property at 12 percent interest with a 1.10 coverage ratio, the payment of the $1.5 million lease buy-up enables him to borrow approximately $3 million in additional nonrecourse finance proceeds. A simple illustration shows how this occurs:

Mortgage Underwriting Before $1.5 Million Lease Buy-Up

(1) NOI	$ 600,000
(2) Required coverage ratio	1.10
(3) NOI available for debt service (line (1) divided by line (2))	$ 545,455
(4) Mortgage available at 12% rate (line (3) divided by .12)	$4,545,453

Mortgage Underwriting After $1.5 Million Lease Buy-Up

(1) NOI	$1,000,000
(2) Required coverage ratio	1.10
(3) NOI available for debt service (line (1) divided by line (2))	$ 909,091
(4) Mortgage available at 12% rate (line (3) divided by .12)	$7,575,758

The formula for the return on a lease buy-up amount can be expressed as follows:

$$\text{Additional refinance sales proceeds} = \frac{\text{Change in NOI}}{i}$$

where i is the capitalization rate times any coverage ratio.

CONCLUSION

The sophisticated real estate investor realizes that the buyout has created only cosmetic value because the property's internal rate of return has remained the same. However, the real estate entrepreneur has now made an unworkable deal work in a complex regulatory and accounting environment that is dependent on cosmetics. The buyout may have created real value for the tenant who has now "booked" the equity that previously was locked in his low-rate lease. If the tenant is a public entity, the stock market probably did not give him credit for his lease-equity position. If the tenant is a regulated financial entity (a commercial bank or savings and loan association), the increase in net worth has an immediate multiplier effect on its lending capability, even though a corresponding decrease in net worth will be written off over the remaining life of its (now increased) lease.