

# **How Commercial Leases Relate to Fundamentals in Commercial Real Estate**

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## HOW COMMERCIAL LEASES RELATE TO FUNDAMENTALS IN COMMERCIAL REAL ESTATE

### INTRODUCTION

The Commercial Lease is the “Plans and Specifications” of commercial real estate. Just as one would not, hopefully, begin to build a building without plans and specifications prepared by an architect/engineer, one is ill advised to endeavor to lease a property without a well-drafted Offer to Lease and Lease.

As we are all aware, the law allows complete freedom of negotiation of the terms of a Lease. Therefore, the Landlord and Tenant are free to establish their own unique agreement.

Also, it goes without saying, the Commercial Lease, once signed, governs the relationship between the Landlord and Tenant and defines their respective roles. More significantly, from an investment perspective, the Lease, as negotiated, is a key element in determining the value of the property. This valuation process is based on certain “educated guesses” and therefore has elements of being an art and science at the same time.

The Commercial Leases which are in place are key to the value of any particular commercial real estate property.

A recent publicly reported example of just how valuable a Lease may be; namely, the Landlord (Cadillac Fairview Corp. Ltd.) paid the Tenant (Sears Canada) \$170,000,000 for Sears’ three Leases in three major city shopping malls – Vancouver’s Pacific Centre, Calgary’s Chinook Centre and Ottawa’s Rideau Centre (source *Edmonton Journal* March 3, 2012).

From a lawyer’s perspective, it is useful to remind oneself regularly that one of the fundamentals of investing in commercial real estate is “caveat emptor”.

As the lawyer, you need to be capable of drafting, advising your client with respect to the Offer to Lease and the Lease and assisting in negotiating the terms of each. Further, if you are advising an investor, either a buyer or seller, you need to be able to assist in the assessment of the existing Leases.

It is also very useful to consider what type of experts can be of particular assistance to you, as the advisor to either a landlord or a tenant. These include:

- (a) A Real Estate Broker who is knowledgeable with respect to the particular market;
- (b) A person who is capable of installing the Tenant's leasehold improvements; and
- (c) An insurance expert who can provide assistance with respect to the insurance provisions.

To get a "flavor" of this process, I give you the following three examples:

- CrossIron Mills – google "CrossIron Mills"
- Enjoy Centre – google "Enjoy Centre"
- Fort McMurray Airport - google "Fly Fort Mac.ca"

### **COMMONLY USED TERMS IN COMMERCIAL REAL ESTATE**

Commercial real estate has its own basic terms. Therefore, when dealing with this "jargon", one needs to seek clarification to understand how each of these terms is being used in a particular set of circumstances.

The four basic terms which will be discussed in some detail are:

- Capitalization Rate – "CAP Rate"
- Internal Rate of Return – "IRR"
- Net Operating Income – "NOI"
- Net Effective Rate – "NER"

The following facts will be used in some of the examples:

- Purchase Price - \$1,000,000.00
- 10,000 square feet
- Gross Operating Income per year comprised of:
  - Net Operating Income  
(10,000 square feet @ \$25.00 per square foot) \$250,000.00
  - Plus Operating Costs  
(10,000 square feet @\$8.00 per square foot) 80,000.00
  - Gross Operating Income: **\$330,000.00**
- Lease Term – 5 years
- Leasing commission – 6% of base rent
- Tenant Improvement Allowance