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REAL ESTATE JUKEBOX
CURRENT HITS TO KEEP TIME WITH MARKET CONDITIONS

June 4, 2009

Money Changes Everything

Buybacks for Concessions Granted to Tenants

THE ISSUE: A key measure of the value of a building is the building's ability to generate net operating income ("NOI"). Depending on the cap rate then prevailing in the market, buyers pay between ten and twenty dollars in price for each dollar of NOI. **Financial concessions, such as protections against tax increases due to reassessment or caps on operating expenses, decrease NOI and, ultimately, the value of the asset -- sometimes significantly**.

SOLUTION: Include a right to buy back the concession from the tenant for an agreed discounted present value. The tenant wins because it gets the equivalent of the present value of the concession. The landlord wins because it has an option to increase NOI with a payment which should be significantly less than the added price the landlord will receive on resale of the building.

DISCUSSION: A building's NOI is a key component for determining value. NOI is the gross income of a building, adjusted for vacancy and credit losses, reduced by operating expenses. NOI divided by the cap rate equals the value of an asset (or at least this is one method, and a very common one, for determining value). The market dictates the range of cap rates being paid in any particular time period. When transactions are few and far between, cap rates rise and buyers are not willing to pay as much for each dollar of NOI being generated by a building. Conversely, when the market is "hot", buyers pay more for NOI and cap rates decline. Cap rates as high as ten percent are not uncommon in the present market. Cap rates as low as five or six percent have occurred in recent memory.

If a financial concession is granted, the effect is to reduce NOI and thus the future value to the landlord on sale of the asset. It is for this reason, among others, that landlords resist such concessions with a vengeance. If concessions are granted, the landlord should include an option to buy back the concession from the tenant for the discounted value of the concessions. **Doing so gives the landlord a way to increase NOI and thus the ultimate selling price of the asset** and, depending on the formula, gives the tenant cash or a cash equivalent to the concession…it could be a win-win strategy for both the landlord and the tenant.

Consider including a buyback in new leases and in amendments to leases that already contain financial concessions.

As the song says: "Money changes everything."

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