

More Free Rent Raises Your Rental Rate

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There are two primary reasons landlords offer so much free rent in a weak market. First, landlords simply need to increase occupancy in a very weak and competitive market to attract new tenants while retaining existing ones. Second, offering free rent allows the landlord to artificially raise rental rates above “market” rates which artificially enhance property values in later years of the lease. Higher property

values better position the property for sale in future years. Accepting higher free rent in lieu of higher tenant improvements allows tenants to pay for moving, cabling and furniture costs not typically reimbursed with tenant improvement allowance.

Many of the office buildings in the DC area are owned by institutional investors who are focused on enhancing the value of their properties versus maximizing cash flow. We are going to calculate the value of a building using the simple “back of the napkin” valuation formula $V = I \div R$ (V = Property Value. I = Net Operating Income. R = Capitalization Rate or “Cap Rate”). The Cap Rate is an individual investor’s required rate of return for an investment. As NOI increases and the Cap Rate remains constant the property value increases.

Many investors analyze the value of a new lease or a renewal for a building based on what is commonly referred to in the industry as the net effective basis using the first year rental rate. Let’s assume your company could negotiate a five year office lease with 5,000 square feet at \$30.00/SF with 3.0% annual escalations, a \$25.00/SF tenant improvement allowance and three months free rent. Leases with free rent add the number of months of free rent to the back of the lease. Over the five year lease term the three months free rent equals \$1.38/SF per year, tenant improvements equal \$4.61/SF per year and the lease commission equal \$1.08/SF per year. The net effective rent is \$22.92/SF ($\$30.00/SF - \$1.38 - \$4.61 - \1.08). If no free rent is offered then the investor would likely lease the space at \$28.83/SF ($\$22.92/SF + \$5.00 + \0.91) to achieve the same net effective rental rate. Investors seeking to maximize cash flow would opt for the no free rent deal.

The escalated rental rates for the above “free rent” deal and the “no free rent” deal are \$33.77/SF and \$32.08/SF, respectively at the end of the five year term. Using the valuation formula above, the property value will be significantly higher for the “free rent” deal than the “no free rent” deal because revenues and therefore net income would be projected to be higher as well.

Contact us to learn more about negotiate free rent and tenant improvement allowances that best meet your company’s needs.