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Real Estate Services, Inc.



A Full Service Commercial Real Estate Company

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Commercial Real Estate Investment Newsletter

A New Style of Corporate Lease Negotiations

A few years ago, senior corporate managers were able to make major real estate decisions by themselves. Now, a negotiating team will negotiate leases. This team may consist of legal counsel, finance department representatives, outside specialists such as real estate brokers or tenant representatives, design and engineering consultants, and others.

In today's market, corporate tenants with high credit ratings, who are willing to make long-term lease commitments negotiate from a strong position. Therefore, corporations that formerly treated real estate transactions in a matter-of-fact way have now developed detailed real estate negotiating strategies. The corporate tenant sees these negotiations as a way to cut costs within the company (whether upsizing or downsizing).

Landlords, developers, and brokers must be aware of this new style of negotiation. While the real estate executive plays a key role in developing the strategy, the other parties must be ready to respond quickly to requests for information and be prepared to discuss issues that rarely if ever arose in the past.

Request For Proposal

The document that best illustrates the new negotiating process is the Request For Proposal (RFP), sent to property owners. The RFP incorporates the specification for rental rates, free rent, up fitting, operating expenses, options, cash incentives and other "money clauses" that the corporation intends to negotiate. A short list of prospective sites or buildings is then prepared based on the initial responses to the RFP. The corporate real estate executive (often with the aid of a real estate

broker) will negotiate to obtain the best deal with the prospective landlords.

The RFP usually contains a number of items that are nonnegotiable—for example, amount of usable square feet, geographic area, lease term, expansion option, parking facilities, and security. On the other hand, many items remain negotiable, such as rent rate, concessions, rent escalations, cash inducements, and amenities. The parties should understand from the outset that failure to obtain a non-negotiable term could kill the deal for the tenant. Other items may be "throwaways" that could be modified or omitted from the lease.

Example: A corporate tenant may lack the capital funds to improve the leased premises, and so may be willing to pay a higher rental rate or extend the lease term in exchange for a larger allowance for improvements. Alternatively, the tenant may be willing to fund all or part of the improvement costs in exchange for a lower rental.

Bargaining position in Negotiations

Although it is obvious that any negotiating process involves give and take by both sides, corporate real estate executives have learned the importance of understanding the strengths and weaknesses of their bargaining position as well as that of the landlord. Within reason, these tenants are assured of getting whatever is needed if the bargaining team is aware of the options and takes carefully calculated risks based on solid information. □

July 2017

This publication is not a solicitation but is an information service from this office.

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When ideas in tax and other legal areas in this publication seem to fit your situation, it is recommended that you discuss them with your professional advisor before taking action.

The Master Lease—A Seller Guarantee

Although office space is in supply in some locations, development has continued. Business leaders are optimistic about the long-term future. Unemployment shows a marked improvement and earnings reports by large corporations are improving.

When new development is occurring in a market and developers are anxious to sell when the construction is complete, use of a master lease may facilitate a sale before the lease-up period is ended. A master lease is a form of seller guarantee that has several specific goals:

- It enables the seller to negotiate a price that reflects a stabilized occupancy and the long-term potential of the property.
- It assures the purchaser of a guaranteed level of income over an initial period and so assures for payment of debt service and equity dividends.
- When an appraisal is a necessary prerequisite for the purchase, the master lease enables an appraiser to value the property without regard to the initial vacancy rate (although certain adjustments may be required).

When a seller agrees to become a master tenant (and so be responsible for the agreed rental

regardless of the actual occupancy level), the seller usually insists on having the management contract for the property for the duration of the master lease to assure an aggressive leasing effort. This also enables the seller to earn leasing commissions and usually is agreeable to the purchaser, which also is interested in achieving full occupancy as soon as possible.

The Terms That Protect Buyer And Seller

The essential purpose of a master lease is to assure the buyer that it will receive a specific amount of cash flow throughout the master lease term. The obligation on the seller can be structured in one of several ways. The seller may guarantee that a certain occupancy level will be maintained or that gross rents will not decline below a specified amount. The lease should contain protective provisions for the buyer; for example, the seller (as manager) should not be able to reduce rents below market merely to achieve a higher occupancy rate. Similarly, the seller-manager should not be able to offer additional and costly amenities in order to increase gross rental revenue. The term of the master lease usually will approximate the estimated time for the property to attain stabilized occupancy. Finally, the obligation of the seller should be secured through an escrow account, letter of credit or other form of guarantee. □

Apartment Complexes Converted To Condos?

The owners of many apartment buildings have found that rental prices have not changed much, and may be thinking about selling. The owner of an apartment complex, rather than sell, realizes the condominium conversion may be a good way to cash out the property.

After sitting out the recession, many professional investors and contractors are now “in the hunt” for apartment buildings that can be converted for profits.

Whether a certain apartment property or complex is suitable for conversion into condominiums depends on these factors:

- It must be in good condition structurally so that a small capital investment can restore it to a safe and marketable condition. These costs may come as a result of the owner’s engineering study or the building code provisions of the political subdivision. This money spent on structural restoration is important but does little to enhance the salability of the units.
- The design and layout of these units should be relatively spacious and functional. If the condominium will be marketable quickly under normal market conditions, buyers must see them as distinct and private apartments.

- It is best if the complex is near shopping and business centers.
- The building or buildings must give the appearance of being durable and refurbished like new so that buyers of a unit can picture it as their permanent residence.
- The best location would be near a neighborhood of single-family homes that are valued at a price substantially higher than the price projected for the completed condominium units. Single-family homes are the competition for condominiums, so a location near higher priced properties makes the condominiums more marketable.

Other favorable factors include:

- A location near a unique neighbor asset such as a park or a school.
- Solid construction including noise dampening insulation, good design, and good parking.
- Existing rentals should be month-to-month or short term leases that can be honored during the conversion.

If these factors are present the complex might be a good property for conversion. The owner or contractor can then begin the necessary feasibility studies as if it was a new property being built from the ground up. □

Proper Management Of Residential Condos

Whether the condos are converted from apartments or built from the ground up, the builder-developer, the project lender and even the unit purchaser in a condominium project should all be concerned with the proper management of the project. Without good management, a project can quickly lose its value and begin a downturn.

The owners in a condo project are free of the day-to-day maintenance cares that beset homeowners. They can best enjoy that freedom when the project is operated and managed by trained and capable people. The fact is that condominium management requires the expertise of a sophisticated professional manager. The manager's skills can be profitably employed during the project design stage, while the building is being completed, and for the ongoing daily operation of the condominium development.

The Design Stage

Skilled professional property managers contribute a good deal to the success of the project by focusing their attention on building into the project low maintenance requirements and durable materials and facilities. They will be concerned with creating trouble free housing accommodations. Their skills complement those of the builder and architect, and their knowledge and experience can be very useful in achieving a set-up that makes for efficiency and economy.

Start-Up Functions

Among the first things a professional property manager will do upon taking over the management of a project is to learn about the buildings and how they work. He or she will determine the stage of completion and when the remaining work will be completed.

Management functions should, as a rule, be separate from construction and maintenance functions. The construction superintendent should not double as the property manager or vice versa. Regular maintenance service should be completely separate from subcontractor follow-up service. In this way, construction costs won't become interwoven with maintenance expenses, and customer services won't become confused.

- **Handling Move-In Problems:** The property manager must schedule move-ins so that everyone can get through this difficult period with the least

amount of friction and with the greatest economy. If the property is a high-rise structure, the problems are multiplied.

Most buildings can't accommodate many move-ins in one day. Physical limitations of truck parking and loading areas, corridors and lobbies, elevators, etc., all impose very definite limits on the number of move-ins that can be handled at one time. In most situations, management will try to handle move-ins on a phase-by-phase basis or even a floor-by-floor basis in large buildings.

- **Parking Problems:** Parking spaces have to be assigned before move-ins are scheduled. Generally parking spaces are assigned on a first-come first-served basis.

If garage parking is insufficient, the property manager might want to provide valet parking so that the aisles can be used. The property manager might set up a parking space priority list. As condominium units are resold, the unit owners that have top priorities are entitled to the newly available spaces.

- **Perfecting Plan for Ongoing Operations:** As the buildings near completion, the property manager will have to negotiate building-service contracts, buy janitor supplies, and perfect and complete pro-forma operating budget. The manager will also help the homeowners' association devise rules and regulations for the orderly operation of the common areas before the condominium-unit owners move in.

In Operation

Once the buildings of a condominium development are completed, occupied, and in operation, a full-time property manager will be responsible for overseeing the operation of the entire development. He or she will be involved, for example, with bookkeeping, housekeeping, planning for the future, keeping peace among unit owners, everyday service problems, move ins and move-outs and much more.

The Managers

The services of skilled, resident, professional property managers are a must for condominium developments of 200 or more units, and are recommended for developments with 35 or more units. Developments with fewer units, say 20 to 30, can also benefit from the services of professional property managers. With 20 units or fewer, the part-time services of a professional property manager might be available for a reasonable expenditure. □

A Land Development Agreement

The acquisition and improvement of land is a large-scale operation and requires large amounts of capital. This has created methods of land acquisition that gives the developer access to and control over a large enough tract to make development economical without requiring an initial outlay of all of the capital necessary to acquire such a tract. From the point of view of the landowner, the disposal of a large tract at a good price may require a formula that will encourage the developer to commit improvement and development money for part of the tract that will build future value into the entire tract.

This may be accomplished by the following:

- The developer sets up a master plan that sets forth the general scheme of development and submits it for the approval of the owner.
- The developer and owner enter into an agreement setting forth the acreage prices for the entire property.
- Owner and developer agree on the number of years over which the full development is to be completed.
- To protect the owner against freezing of his property, the developer firmly commits to buy a predetermined number of acres each year.
- If the developer fails to meet this schedule, the owner is released from his commitment.

A Development Agreement

Another way of handling the problem is for the developer to share the net profits from the land development

with the landowner. This can be done by a “land development agreement” in which the developer agrees to perform the platting, the laying out, the installation of lot improvements, and the promotion of the subdivision. The landowner agrees to accept a percentage of the sales price of each lot, with a fixed minimum guaranteed. For example, the developer agrees to pay net to the landowner 25% of the sales price of each lot sold, with a minimum of \$50,000 per lot.

With this kind of arrangement, it is important to protect the landowner from finding his land cluttered up with liens left by a subdivider who went broke. The landowner should consider confining the developer or subdivider to a small tract of land at a time and give him “rolling options” to acquire additional parcels at intervals over a period of time. Failure to keep up with this purchase program results in loss of future options. The land that has been optioned but not purchased is not subject to liens against the developer.

A Liability for Not Proceeding With Development. In one case, a jury found that a village breached its contract with a real estate developer calling for the village to acquire property and convey it to the developer for construction of apartment houses and a shopping center, all conditioned on obtaining financing from HUD. The village repudiated its explicit undertakings, to acquire and convey property to the developers. HUD had granted the main application and was in the process of considering the other grants involved, so the village could not back out of its promise. [*Heritage Commons Partners v. Village of Summit*, 730 FSupp 821, (ND Ill. 1990)] □

Commercial Real Estate Representation

There are a number of ways to buy, sell or exchange investment or commercial real estate. Having the knowledge of what you can do in some tax situations can be the difference between an annual profit or loss in a property that you intend to acquire or one that you already have in inventory.

The professional commercial real estate broker is in the position to represent clients in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate. A professional real estate practitioner must stay aware of current tax laws and court decisions in order to structure transactions, but does not give legal or tax advice (unless he/she is also an attorney or a certified public accountant). In any complex transaction

that might result in changes in any owner’s legal or tax situation, the other members of the “consulting team” should be the owner’s attorney and CPA. We always recommend meeting with these other professionals during the planning and closing of major real estate transactions.

As commercial brokers, we are part of your professional team. It is our job to create the real estate transactions that will be needed to enhance your estate. We should meet with our clients on a regular basis to evaluate their present position in properties, reviewing plans for future acquisitions or exchanges.

Reviewing your plans and goals can give us the information needed to help us in moving you in new directions as soon as possible, using purchases, sales or tax deferred exchanges. □

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