Modern lease monetisations: How to capitalise on market arbitrages to significantly reduce occupancy costs

Received (in revised form): 2nd April, 2022

Bob Mohr

Rodrigo Godoi

Elizabeth Loving

Bob Mohr*

Founder and Chairman, Mohr Capital, USA

Rodrigo Godoi**

Managing Director, Mohr Capital, USA

Elizabeth Loving†

Senior Advisor, Mohr Capital and Director, Mohr Partners, USA

Bob Mohr *is Founder and Chairman of Mohr Capital, a Dallas-based commercial real estate investment company that acquires, develops and value enhances corporate office, industrial and retail properties. Since its inception in 2000, the company has completed more than US$2.5bn in transactions. Prior to founding Mohr Capital, Bob served as Chairman and CEO of Mohr Partners, a global corporate real estate advisory company. He formed Mohr Partners in 1986, amid Dallas's great economic and real estate downturn, and when he sold the company in 2017, it served occupier clients in more than 70 countries through 24 US offices and three international alliances. A native of Indiana, Bob is a current Board Member of the Fitzgerald Institute for Real Estate at the University of Notre Dame and previously served on the Board of the Real Estate Council.*

Rodrigo Godoi *is Managing Director of investments for Mohr Capital, a Dallas-based commercial real estate investment company that acquires, develops and value enhances corporate office, industrial and retail properties. He oversees the entire life cycle of an investment and takes a hands-on approach from the concept phase of a project through to its completion. Rodrigo has actively built Mohr Capital's investment portfolio by resolutely managing nationwide acquisitions and dispositions of office, industrial, hotel and ground lease assets. He has executed more than US$2bn of transactions in his career. Originally from Santos, Brazil, Rodrigo holds a Bachelor of Science in economics from Louisiana State University and a master's degree in real estate from Cornell University. He is a member of NAIOP and is actively involved in the Cornell Real Estate Council's Dallas Chapter.*

Elizabeth Loving *is Senior Adviser at Mohr Capital, a Dallas-based commercial real estate investment company that acquires, develops and value enhances corporate office, industrial and retail properties. She also serves as Director for Mohr Partners, a global corporate real estate advisory firm. In her role at Mohr Capital, Elizabeth collaborates and strategises lease monetisation opportunities for corporate users occupying office, retail and industrial speculative and build-to-suit properties to reduce occupancy costs and create value through their real estate. At Mohr Partners, she advises and oversees corporate real estate portfolios across*

*14643 Dallas Parkway #1000,
Dallas,
TX, 75254,
USA*

**Mob: +1 214-415-0444;
E-mail: bob@mohrcap.com*

***Mob: +1 214-924-6538;
E-mail: rodrigo@mohrcap.com*

†*Mob: +1 214-794-5422;
E-mail: elizabeth@mohrcap.com*

Corporate Real Estate Journal
Vol. 11 No. 4, pp. 314–333
© Henry Stewart Publications,
2043–9148

North America. Elizabeth is a licensed real estate professional and holds Bachelor's and Master's degrees in music with a concentration in voice performance from Texas State University and Roosevelt University, respectively.

Abstract

This paper introduces the concept of lease monetisation and details this lucrative strategy, which allows occupiers to generate a significant cash incentive from restructuring their lease to reduce their occupancy costs even further, while securing long-term control of an asset without an ownership interest or investing their capital. This paper explains the lease monetisation process, including the way corporate occupiers can decrease occupancy costs through long-term leases by taking advantage of arbitrage opportunities in the capital markets, the types of properties suitable for lease monetisations and the importance of corporate credit.

Keywords: lease monetisation, mission-critical facilities, cap rates, investment partner, value arbitrage, profit participation, cash incentives, lease restructure, investment-grade credit

AN UNCOMMON STRATEGY

Very few corporate real estate (CRE) occupiers of single-tenant net-leased (STNL) properties understand the actual value of their lease from their landlord's perspective. Having a clear understanding of how capital markets value short-term versus long-term leases allows CRE executives to monetise their leases and lower long-term occupancy costs in their mission-critical facilities.

The most basic real estate monetisation strategy is a sale-leaseback — the process of creating value from real estate by selling owner-occupied facilities and immediately leasing it back from a new landlord for a long period of time. CRE executives can also monetise their lease even if they do not own the property they occupy, a strategy called lease monetisation.

Over the past three years, Corporate America's stance on its real estate and leasing decisions has evolved. By implementing FASB ASC 842, corporate occupiers gained a better understanding of the financial impact of their lease decisions, while the COVID-19 pandemic challenged their views on leased facilities, particularly office properties.

In a COVID-19 world, occupancy costs and other pandemic-related considerations became even more important variables for CRE executives to worry about, including:

- What are the new long-term consequences for occupiers?;
- Will office properties eventually revert to pre-COVID-19 occupancy levels?;
- Is the new hybrid work model the new normal?;
- How does COVID-19 affect corporate occupiers' lease decisions?;
- What is the amount of space needed for specific organisations to function properly?

Most have conducted internal studies to determine their space needs based on what they believe is the new work model for today and tomorrow. Different industries have different views on occupied space, but at every level, these discussions are occurring at every major corporate office.

With the increased adoption of hybrid work (see Figure 1), most US companies expect employees to work in the office 2.5 or more days a week.[1]

To that end, some companies are dialling back their use of leased space. In the US, 44 per cent of companies expect their portfolios to contract over the next three years (see Figure 2), almost exclusively driven by large companies.[2] The degree to which they expect to scale back their portfolio, however, has moderated their sentiment throughout the pandemic. In general, occupiers continue to target high-quality properties in prime locations to satisfy employee expectations.

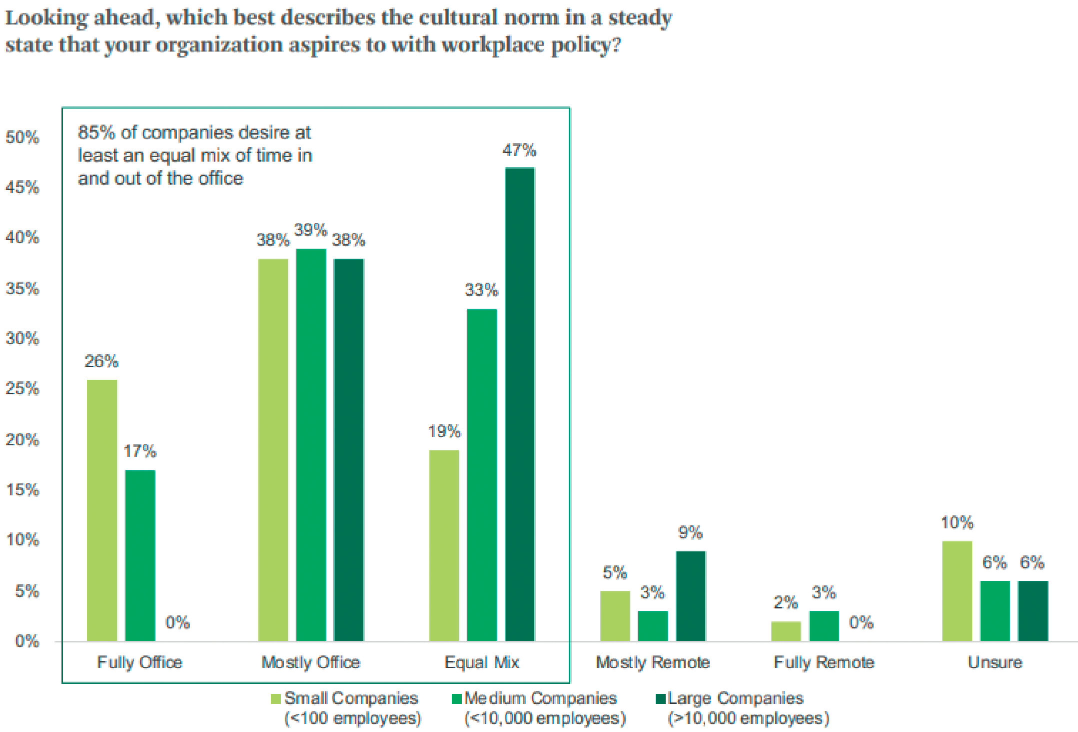

Figure 1 Increased adoption of hybrid work
Source: April 2021, United States Occupier Sentiment Survey

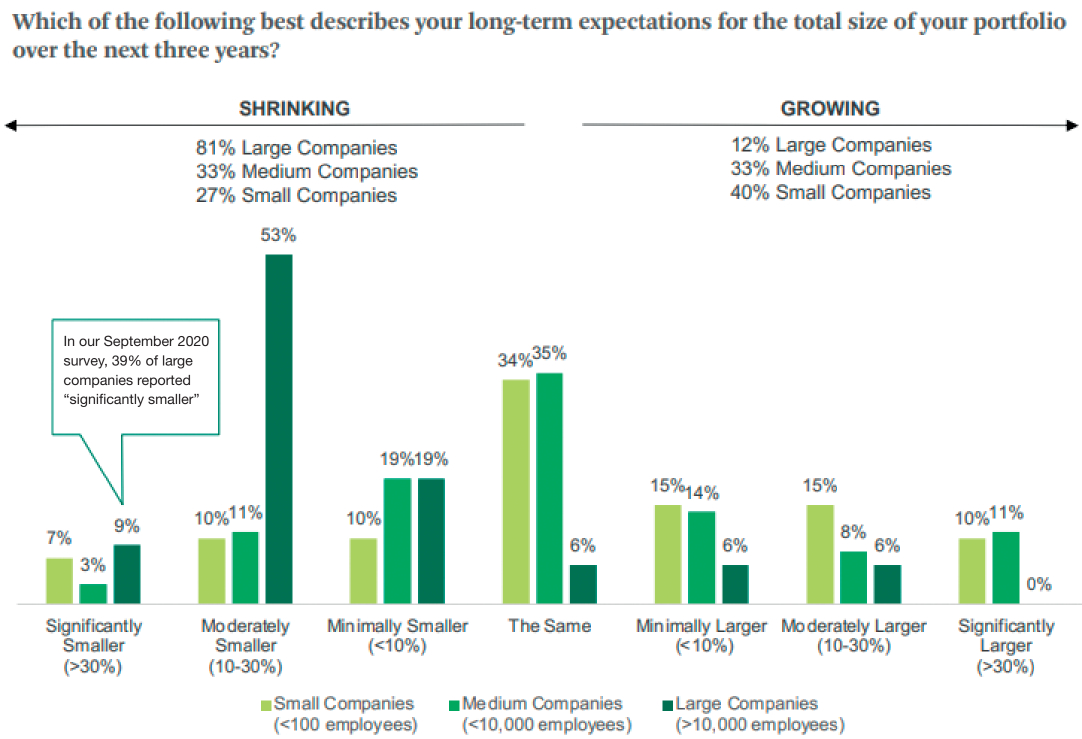

Figure 2 Long-term expectations for company portfolios
Source: April 2021, United States Occupier Sentiment Survey

Meanwhile, others are transforming their spaces to facilitate proper social distancing requirements for their workforce and create a workplace destination, often concluding that they need more space to accommodate their needs. By and large, companies are looking to develop more collaborative office spaces to help employees work together in-person. Some changes will be more immediate, such as enhanced video conferencing (see Figure 3).

Once an organisation decides on an occupancy strategy, how does that strategy affect lease terms? While some companies prefer to maintain flexibility at all costs, exchanging higher occupancy costs for the flexibility of shorter lease terms, those with a clearer view of their long-term growth strategy can choose longer-term leases in exchange for lower lease costs.

Although the answers to these questions are industry-specific, occupancy costs are still the dominant variable every organisation is trying to tackle. This paper offers CRE executives a better understanding of one strategy they can add to their playbook to address occupancy costs in their mission-critical facilities.

Any CRE occupier of STNL properties can take advantage of modern lease monetisation strategies, applying the same principles to any leased asset, whether a suburban office campus, a warehouse or freestanding retail. Companies that have pursued lease monetisations have a few things in common, most notably:

(1) A clear understanding of their long-term corporate strategy and how their portfolio of leased properties complements their growth;
(2) A portfolio comprised of hundreds of thousands (if not millions) of square feet;
(3) Mission-critical facilities in their portfolio.

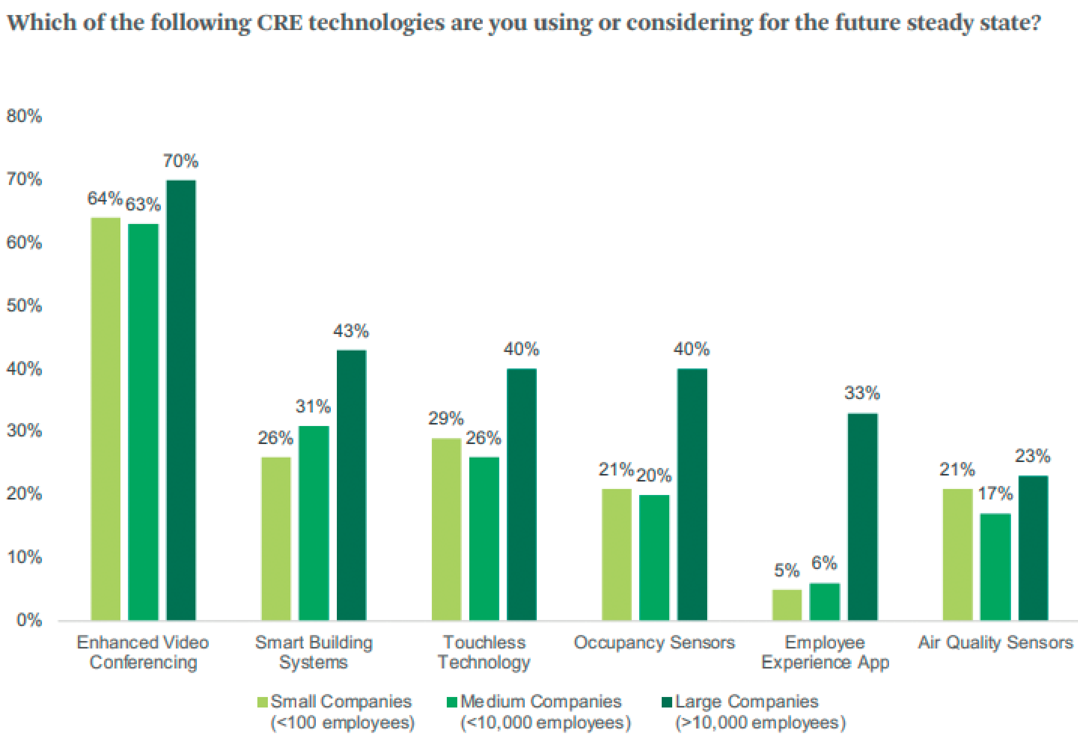

Figure 3 Company developments to facilitate social distancing requirements
Source: April 2021, United States Occupier Sentiment Survey

WHAT IS LEASE MONETISATION AND WHAT ARE THE BENEFITS?

At its most basic level, monetising leased assets is a strategy for an occupier to receive a cash incentive for the value its restructured lease brings to the property. Occupancy and lease terms are the most important variables that determine the value of a single-tenant property.

Buildings trade hands all the time, but tenants rarely realise any of the upside created by their lease terms, other than the typical tenant improvements (TI) and/or free rent negotiated in lease renewals. Lease monetisations take advantage of the value arbitrage between a short-term and a long-term lease and allow users to participate in a portion of the new value created by their lease without having to take any ownership position or invest any of their capital.

Lease monetisations require a partnership between an investment partner and the corporate occupier. An investment partner is necessary because the current landlord usually is not in a position to offer the occupier a significant enough lease restructure incentive when only a short term remains on the existing lease.

Due to typical loan covenants, most investors would be forced to either restructure their loan or do an equity call to fulfil a potential lease restructure incentive package halfway through their investment hold period. This makes a lease monetisation strategy a bit more difficult for occupiers to execute with their existing landlords.

Once the corporate occupier identifies its mission-critical facilities, the investment partner will work to acquire the facility from the occupier's current landlord. Due to the shorter lease terms remaining on these transactions (typically eight years or less), these acquisitions are executed at a discounted rate to the value of the same building if it had a long-term lease (ten-plus years). This creates an arbitrage opportunity that corporate occupiers can exploit by extending their lease term on mission-critical facilities beyond the ten-plus year mark.

By extending the lease term, the tenant helped to increase the value of the property, thereby allowing an investment partner to use less expensive debt to finance the property acquisition and share that arbitrage with the corporate occupier. In doing so, the tenant usually realises a much larger present value (PV) benefit than if it had waited years to renew the mission-critical facility lease, only to receive a market-rate TI allowance.

For example, Mohr Capital executed a lease monetisation with a publicly traded semiconductor company for a 207,000sq. ft office/research and development (R&D). The tenant had invested heavily in this R&D facility, which also serves as its headquarters, with several clean rooms and labs, located in Northern California. Five years remained on the lease.

As Mohr Capital acquired the property, it worked with the user to arrive at an appropriate incentive to extend its lease commitment to 11 years by exercising its next renewal option early. In lieu of a cash incentive, the tenant preferred a substantial rent reduction of more than 13 per cent and additional renewal options that allow it control of the facility for the next 21 years at rental rates 25 per cent below market.

The method by which the investment partner compensates the corporate occupier depends on what the occupier values most. The easiest method is offering the occupier a cash incentive upfront, typically 25–50 per cent of the arbitrage, depending on occupier credit, cap rate spreads, level of parent guarantee, debt markets, structure and length of the leases and geographic location.

On a hypothetical office building of 250,000sq. ft, this arbitrage can be significant (see Figure 4).

For a lease monetisation to work, occupiers need a tenant-friendly lease that gives them more control than a standard landlord

Sample Office Building

RSF		250,000
Rental Rate		$30/SF
NOI	$	7,500,000

Lease Term		**Valuation**	**Cap Rate**
10 Years	$	125,000,000	6.00%
5 Years	$	100,000,000	7.50%

Arbitrage = $25,000,000

50% of The Arbitrage in this Scenario = $12,500,000 = $50/ SF

Figure 4 Sample arbitrage

lease. Investment partners must make sure tenants are comfortable with the lease terms. For some, that means fixed-rate renewal options, control of expenses, expansion rights, or limits on financial disclosures.

Although many investors are adamant that the money be used on the property itself, the most sophisticated investment partners will allow occupiers to use incentive dollars generated through a lease monetisation however they wish. Some of those uses include rent credit, improvements to the building, furniture, new manufacturing equipment and trucks, and dividends to shareholders. Occupiers have full discretion; the investment partner only issues the cheque.

Many corporate occupiers prefer to use their lease monetisation incentives as straight-line rent. In that scenario, the incentives have a direct impact on their balance sheet and lower their overall occupancy cost. Others prefer a typical TI allowance or a combination of rent reduction and TI.

As an example, Mohr Capital worked with a publicly traded insurance company on a lease monetisation with five years remaining on the tenant's lease. The tenant needed to invest millions in equipment at the mission-critical facility. The tenant's objective in doing a lease monetisation was to secure long-term control of an 80,000sq. ft office with a pharmacy distribution component and reduce occupancy costs in the process.

Mohr Capital offered a cash incentive at closing of approximately US$2.5m, plus a reduction in the annual rent growth rate. The total investment package was well above the market renewal TI allowance for this type of property had the tenant made the decision of just waiting to renew. The incentive had no restrictions on how to use the money, and the tenant chose to spend it on upgrading its pharmacy component of the building. In exchange for the cash and flexibility, the tenant agreed to an 11-year lease with additional renewal options allowing it to control the facility for the next 22 years at below-market rates.

Another option for more opportunistic corporate users is to negotiate a profit participation of 15–30 per cent with the investment partner in lieu of an upfront cash incentive. In this scenario, the corporate user will benefit from the value creation once the investment partner sells the property. Depending on capital markets, the total dollars the corporate occupier can receive could be substantially higher than the upfront cash incentive outlined above; however, the occupier will be at the whim of the investment partner to decide when it is appropriate to sell the asset.

Experienced investment partners will outline a menu of options for the corporate user to pick from, which gives the user flexibility on how to take advantage of that incentive package depending on their appetite for risk. More risk-averse occupiers would gravitate towards upfront cash incentives, while more aggressive users could hedge the markets by taking some of the incentive upfront and some of it in the form of a profit participation.

Some occupiers look to ensure stable ownership, while others are eager to secure a location for the long term at current low-rent levels. Some hope to gain more control over their buildings, and others want to make improvements and updates. The most sophisticated investment partners will even work with corporate users to maximise the tax effect of this incentive. For example, this could be in the form of the landlord acquiring the equipment on behalf of the tenant and then leasing the equipment at zero cost to the tenant.

All those objectives can be achieved with a lease monetisation. Incentives are typically funded after the property trades hands. At that time, an occupier will receive a share of the value created by its lease extension. Typically, it is no less than the value of one year's rent but can be up to four years' rent under the right circumstances.

IS LEASE MONETISATION OF MISSION-CRITICAL FACILITIES A GOOD IDEA FOR MY ORGANISATION?

CRE executives need to ask themselves five key questions when considering lease monetisations:

(1) What are my organisation's short-term and long-term growth plans and how does real estate fit into that plan?;
(2) Are there geographic areas that we know we want to be in for the long term?;
(3) Do we have mission-critical facilities in those areas?;
(4) Are there any circumstances in which we would not want to be in this market/building?;
(5) Are the remaining lease terms on these facilities less than eight years?

As public and private companies implemented and continue to implement FASB ASC 842, discussions around its impact on lease-term strategy typically centre around the benefits of shorter lease terms under the new guidelines. In reality, there has been very little movement toward shorter lease terms due solely to ASC 842.[3]

One of several reasons for this is the tenant's accounting treatment of a lease that contains extension options. Most leases contain extension options, and the corporate user may have already included the renewal periods in the measurement of the lease liability and right-to-use asset if they were reasonably certain to extend them.

To illustrate, consider that an occupier leases two separate mission-critical buildings of the same size and at the same rental rate:

(1) For building 1, the user renews its lease for five years and adds two five-year renewal options in exchange for typical renewal TIs of US$5/sq. ft;
(2) For building 2, the user renews for ten years and adds one five-year renewal option. Given the longer-term lease, the landlord offers TIs of US$15/sq. ft.

In both instances, upon renewal, the user will remeasure its lease liability and adjust the carrying amount of the right-to-use asset by the amount of the remeasurement of the lease liability. The lease liability is remeasured as the PV of the remaining lease payments that includes the renewal option period using a revised discount rate.

The right-to-use asset is adjusted by the amount of the remeasured lease liability and will include the remaining balance of any lease incentives received, cumulative prepaid or accrued rent and any unamortised initial direct costs. It is also adjusted for any additional lease incentives received/paid or additional initial direct costs paid.

Since both buildings are mission-critical facilities, as long as the extension periods of both leases are deemed to be 'reasonably certain' to extend (and they typically are in these facilities), corporate users would use roughly the same term for each scenario under ASC 842. In fact, the higher renewal incentives granted for building 2 will result in a lower lease liability/right-to-use asset on the books. Using FASB ASC 842 as a general excuse to procure shorter lease terms on mission-critical facilities is a sure way to leave money on the table when negotiating a lease renewal.[4]

A lot of corporate occupiers are hesitant to commit to long-term leases because they want to ensure and preserve flexibility. Many feel that long-term leases are inherently risky because it is difficult to predict future real estate needs. They are willing to assume the market-related risk — the likelihood that they will end up paying more when market conditions shift — as well as pay more rent on their existing leases because they are shorter than most landlords prefer. Those organisations that place a premium on flexibility are not the best candidates for lease monetisation.

This strategy works best for organisations that have a long-term plan to meet their growth strategy, with real estate occupancy being part of their growth plan. To fully benefit from a lease monetisation, occupiers must have clarity regarding their existing real estate portfolio and their future real estate needs. If a user feels confident in its long-term occupancy of a specific location, a lease monetisation could be a good option, depending on the lease term.

A mission-critical facility is any location the occupier has deemed as critical to its operations and future growth plans. Examples of mission-critical criteria include the quality of the labour pool in the area, heavy investment in the facility over the years, the existence of local and state incentives to create jobs in the area, or logistical reasons in the portfolio. As a result, most corporate users will typically occupy their mission-critical facilities for a much longer period than their non-mission-critical leased space.

A quick look at what corporate users have done with their office leases over a 15-year span provides an idea of how often occupiers simply renew in place.

Figure 5 summarises how often occupiers of single-tenant office space of at least 100,000sq. ft renew in place instead of relocating. The probability that an occupier would renew in place averaged 85 per cent for the 15 years pre-COVID-19, and this statistic does not take into account how mission-critical the facility was. In comparison, the average renewal rate on multi-tenant office buildings was just 59 per cent over the same period.

In general, the lease renewal rate of mission-critical facilities is much higher than the renewal probabilities on the remaining leased real estate facilities in a company's portfolio, regardless of the corporate occupier's lease strategy as it relates to lease terms. If an occupier has been at the same mission-critical facility for 20 years, renewing leases every five years, there is no doubt this occupier has left substantial dollars on the table. Was the perceived flexibility worth the much higher occupancy costs?

Understandably, COVID-19 has affected corporate users' lease decisions. While many industry professionals believe the 85 per cent renewal rate shown in Figure 5 will decrease over the next couple of years, the rate at which occupiers renew their mission-critical facilities will not change.

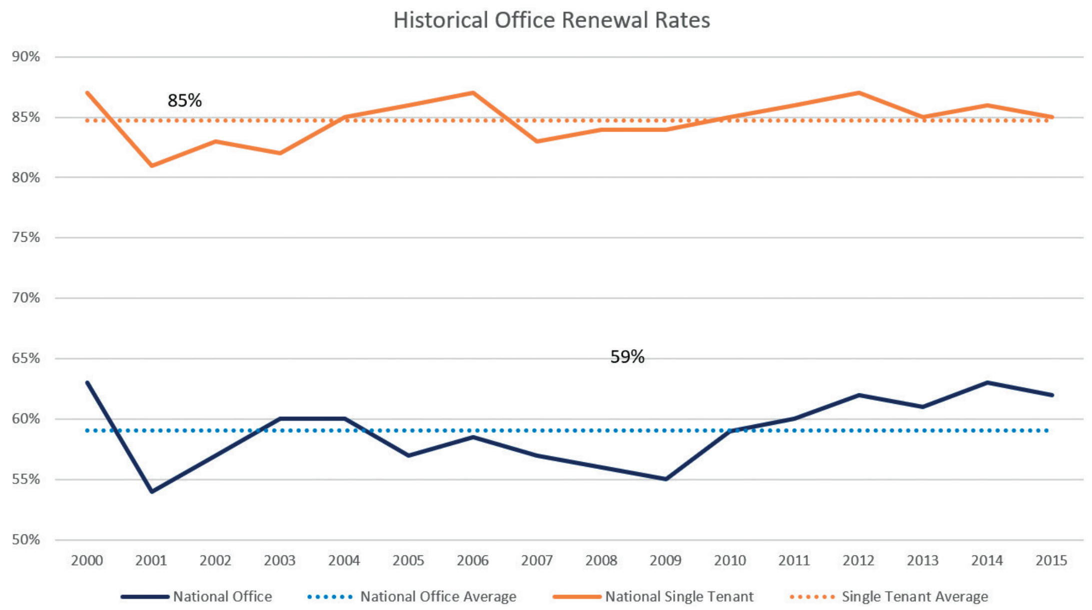

Figure 5 Renewal probability (single versus multi-tenant)
Source: CoStar Portfolio Strategy

LEASE TERM AS THE SOURCE OF THE ARBITRAGE OPPORTUNITY AND DETERMINANT OF VALUE

A building's value is determined by its ability to generate net operating income (NOI), and that NOI is generated from rent. By and large, unoccupied buildings are worth less than occupied buildings (unless there is a plan for the building for an alternative use).

Investors are willing to pay a lower cap rate (higher price) for longer lease terms since they provide stability and security of cash flow. Buildings with less than eight years typically trade at a discounted price (higher cap rate) relative to their ten-plus-year counterpart due to increased risk of lease expiration exposure. Simply put, all things being equal, the same building with the same tenant with a ten-year lease term is worth a lot more than a five-year lease.

The universe of buyers for STNL properties with less than ten years of lease term is very small. Ten years is an important hurdle, since many net lease investors, pension funds and real estate investment trusts (REITs) cannot or prefer not to acquire a net leased property with less than ten years left on the lease. When the universe of buyers is reduced, the price of the asset is reduced.

Why does lease term matter so much to investors and landlords? Perhaps most importantly, buildings with short-term leases are difficult to finance. It is extremely expensive for an investor to acquire a short lease term, single-tenant asset. Most lenders want some sort of guarantee from owners that the building will generate enough NOI from rents to pay the mortgage. Buildings with short-term leases are more vulnerable to vacancies and less likely to continue to collect rent over the long term if a tenant decides to vacate, creating an additional layer of risk for the lender.

Figure 6 shows the differences in valuation/cap rates between single-tenant office transactions where the user had lease terms between five and 12-plus years of lease terms.

In summary, two lease term hurdles that significantly affect value include:

US | Single Tenant Office
Single Asset Closed Sales, $10m+

Avg Cap Rates	Lease Term: 5-8 Yrs	Lease Term: 10-12 Yrs	Lease Term: >= 12 Yrs
2015	7.4%	6.7%	6.3%
2016	7.3%	6.9%	6.3%
2017	7.0%	6.0%	5.9%
2018	7.1%	6.5%	5.8%
2019	7.0%	6.1%	6.0%
2020	7.5%	6.0%	5.8%

Figure 6 Differences in valuation/cap rates between single-tenant office transactions
Source: Real Capital Analytics

(1) When lease terms fall below 12 years — cap rates increase by 20 to 25 basis points, decreasing the value of the property accordingly;
(2) When lease terms fall below ten years — cap rates increase by 50 basis points or more. In some cases, cap rates increase by 400 basis points when the lease term falls below five years, creating the large arbitrage opportunity.

A simple example shows the difference in valuations and the arbitrage opportunity.

Let us assume a deal that sold in January 2020 was a 250,000sq. ft single-tenant facility where the tenant's net rental rate was US$30/sq. ft. That is the equivalent of a US$7.5m NOI for 2020 for year one rent (US$30 × 250,000sq. ft) (see Figure 7).

If that tenant had five years of lease term remaining, according to RCA, at the 7.5 per cent average cap rate, the value of that building was US$100m (US$7.5m million/7.5 per cent). If that same tenant had ten years of lease term, at a 6.0 per cent average cap rate, the value of the building jumped by 25 per cent to US$125m (US$7.5m /6.0 per cent). That represents an additional US$100 per sq. ft in value creation by going from five years of term remaining to ten years.

Renewal incentives, or TIs, in most markets rarely surpass US$20/sq. ft for a typical five-year renewal; however, the value creation of such a renewal in this example would have been US$100/sq, ft.

If the user was willing to exercise an early renewal and extend its lease to a total of ten years, despite having five years of lease term remaining, the investment partner would have been able to share that arbitrage with the user 50/50. The user's renewal incentive would have been US$50 per sq. ft or US$12.5m — the equivalent of 20 months of free rent.

Most renewal negotiations for a five-year lease term extension rarely reach this level of incentive. Instead, occupiers must execute a lease monetisation strategy with an investment partner in order to achieve these levels of incentives. In the example above, had the tenant waited five years to renew for an additional five years, it would have received an average of US$20/sq. ft in tenant improvements (US$5m) in a best-case scenario, leaving US$7.5m on the table.

When both options are compared using a prevent value (PV) calculation at the user's current return on equity (ROE) as the discount rate, the difference is staggering.

Assuming the tenant has an ROE of 20 per cent, if the tenant waited five years to renew, the PV of the lease renewal incentive (US$5m) that is occurring five years from now is just US$2,009,388 today, versus the

Hypothethical 250,000 SF Office
Rental Rate: **$30/ SF**
Rent Growth **2% per Year**

Year	Rent	
2020	$ 7,500,000	Current Remaining Lease Term
2021	$ 7,650,000	
2022	$ 7,803,000	
2023	$ 7,959,060	
2024	$ 8,118,241	
2025	$ 8,280,606	Extension Period
2026	$ 8,446,218	
2027	$ 8,615,143	
2028	$ 8,787,445	
2029	$ 8,963,194	

Figure 7 Difference in valuations and the arbitrage opportunity

current US$12.5m incentive. This is a significant benefit to the tenant of more than US$10m by making an earlier decision to extend (see Figure 8).

The analysis becomes even more interesting when you compare the net present value (NPV) of the rent in the lease extension period to the lease monetisation incentive (see Figure 9).

By executing on the lease monetisation strategy, the user essentially paid for all the rent on the extension period with the upfront landlord incentive of US$12.5m (US$50/sq. ft) on a NPV basis at the user's 20 per cent ROE discount rate (US$10,284,621). Even when accounting for the PV of the US$5m renewal TI in year five (US$2,009,388 today), the

	Year	Rent	Lease Monetization Incentive	Normal Renewal Incentive
			$12,500,000	$2,009,388
Current Remaining Lease Term	2020	$ 7,500,000		
	2021	$ 7,650,000		PV
	2022	$ 7,803,000		
	2023	$ 7,959,060		
	2024	$ 8,118,241		$5,000,000
Extension Period	2025	$ 8,280,606		
	2026	$ 8,446,218		
	2027	$ 8,615,143		
	2028	$ 8,787,445		
	2029	$ 8,963,194		

Figure 8 Lease monetisation incentive versus normal renewal incentive

	Year	Rent	Lease Monetisation Incentive	NPV of Renewal Rent Yrs 6-10
			$12,500,000	$10,284,621
Current Remaining Lease Term	2020	$ 7,500,000		$0
	2021	$ 7,650,000		0
	2022	$ 7,803,000		0
	2023	$ 7,959,060		0
	2024	$ 8,118,241		$0
Extension Period	2025	$ 8,280,606		$ 8,280,606
	2026	$ 8,446,218		$ 8,446,218
	2027	$ 8,615,143		$ 8,615,143
	2028	$ 8,787,445		$ 8,787,445
	2029	$ 8,963,194		$ 8,963,194

Figure 9 Lease monetisation incentive versus NPV of renewal rent years 6–10

net upfront incentive of US$10,490,610 (US$12,500,000–US$2,009,388) pays for all the rent in the extension period at the 20 per cent ROE discount rate in this scenario.

While this example was based on real cap rates we observe in the market, the results will be different on every deal given the differences in real estate markets, credit ratings of the user, cap rate spread between short and long lease terms, etc. Nevertheless, it highlights the advantages of working with an investment partner to capitalise on this arbitrage opportunity to lower occupancy costs instead of simply waiting for a likely renewal.

CHOOSING THE RIGHT INVESTMENT PARTNER

CRE executives should prepare in advance to monetise their lease in order to create substantial value for their company. Most landlords, however, are not willing to share that upside with a user from a newly signed lease during their investment hold period. That is where an investment partner steps in.

Finding and choosing the right investment partner for a lease monetisation is the most critical element of successfully executing this strategy. The importance of making a smart decision cannot be overstated — without the right partner, the deal will stall and ultimately fail.

CRE executives should consider several things when evaluating an investment partner:

- *Access to capital*: Is the investment partner internally funded or do they have investors? Will they need to raise capital or create a new fund to finance the lease monetisation? The answers to these questions are important because they can have an impact on the overall terms of the deal, as well as the timing. Partners with internal funding usually are more flexible than those with complex investment committees. If the partners need to obtain approval from their investors or adhere to a specific set of fund covenants or requirements in the process, the company may not necessarily be the best investment partner;
- *Experience*: Has the investment partner ever successfully pursued and executed a lease monetisation with a large Fortune 500 corporate user? A partner with experience in lease monetisation will be able to guide an occupier and their advisers more effectively than a partner without that experience. Does the investment

partner have a history of collaborating with corporate users and their third-party service providers? An investment partner's track record working with corporate users is as important as its experience executing this type of deal. Familiarity with similar organisations and their objectives and processes smooths the path to lease monetisation;
- *Investment horizon*: Is the investment partner a long-term holder or a value creator? An investment partner that focuses on steady, stable cash flow over a long period has a different approach to deal making than an investment partner that strives to create value in each and every situation. A lease monetisation deal is, at its heart, a way to extract as much value as possible out of a lease for both the tenant and the investment partner, creating the largest arbitrage possible that will substantially reduce occupancy costs.

A wide range of investors have an interest in and are willing to do lease monetisations; however, there are not many with experience and a track record in closing these types of deal. Investment partners that have experience with this type of lease monetisation can streamline the process for the tenant, minimising the risks at every stage of the process.

Corporate credit plays an important role in lease monetisations. Besides lease term, the value of the lease is directly correlated to the strength of a tenant's credit, and buildings occupied by creditworthy tenants are valued higher by buyers and lenders.

Publicly traded companies are ideal candidates for lease monetisations, primarily because their debt is typically rated by third-party rating agencies (Moody's Investors Service and S&P Global Ratings). From an investment partner's perspective, these ratings provide insight into the creditworthiness of the tenant and make it easier to assign a value to a lease and appropriately price the property.

While it is much easier to pull all the pieces together for a lease monetisation when the corporate user is publicly traded, private companies can also pursue lease monetisations, albeit via a different process.

Organisations with investment-grade credit will generate more upside through a lease monetisation than those with non-investment-grade credit; however, that does not mean lease monetisations are not also worthwhile for privately held tenants.

For private companies without public debt to move forward with a lease monetisation, they must be willing and able to share in-depth financial information so the investment partner can make its own assessment and assign its own synthetic credit rating — one that is equivalent to Moody's or S&P. This additional financial information typically covers three years of financials, including total assets and total liabilities. Tangible assets are far more important than intangible assets from an investment partner's perspective and a capital markets perspective.

BIGGEST DRAWBACKS TO LEASE MONETISATIONS

There are not many drawbacks unique to lease monetisations. Because the strategy is similar to any other lease from a tenant perspective, the biggest risk to an organisation is being locked into a long-term lease in a facility it no longer needs.

This is why it is so important for CRE executives to have a solid real estate strategy that correlates with the company's long-term growth strategy and to conduct due diligence on the front end, well before they begin negotiating a lease monetisation. The plan should identify the sites and locations that will continue to be mission-critical in the near and long term, allowing the organisation to make smart leasing decisions that will benefit it now and in the future.

One potential risk or drawback to a lease monetisation is the same as for any financial deal: the possibility that the property acquisition falls through. This could happen for a variety of reasons, most of which are out of the tenant's sphere of influence. In this scenario, an occupier expects to receive a big incentive package and makes plans for the funds, but they never materialise. Depending on the tenant's financial situation — if it was counting on that money and had already made commitments — the inability to close on a lease monetisation could cause considerable hardship, and all the time and resources invested in the deal end up being squandered.

CRE executives may also run into issues with their executive leadership and boards of directors when trying to execute a lease monetisation. It is not unusual for chief financial officers to avoid committing to a long-term lease if they have not had the time and/or opportunity to properly evaluate the lease monetisation proposal with their CRE executives. To that end, corporate users whose CRE executives are closely aligned with the C-suite's long-term growth plans have an easier time obtaining executive buy-in and approval early in the process.

At the same time, another risk bubbles up when an organisation's executive team excludes its real estate executives from important business-related conversations that heavily affect its real estate portfolio — for example, impending mergers, acquisitions, dispositions or other material events. If the CRE executive aims to minimise occupancy costs, collaborating closely with the C-suite to be apprised of these key business decisions will undeniably prevent the wasted effort of exploring a lease monetisation on a property that will not be occupied long-term.

Lastly, lease monetisations can run into roadblocks that have nothing to do with the occupier, the investment partner or the future owner. Some common challenges that arise during the course of a lease monetisation deal include environmental issues or other problems with the property that cannot be remedied in time for a successful execution of the strategy. Unfortunately, there is no way of knowing when these problems will occur. Even worse, they are completely out of a tenant's control.

TIMING IS EVERYTHING FOR A LEASE MONETISATION

Before beginning negotiations for a lease monetisation, CRE executives need to determine the key players that need to be involved in the transaction, both internally and externally. More often than not, the internal team includes the CFO, head of real estate, and at least one member of the company's legal group.

Many corporate users that work with their real estate service providers on a regular basis want them to be involved in a lease monetisation. Although a lease monetisation deal can be executed without a broker; more sophisticated investment partners welcome the opportunity to work with these services providers that share the same goal of maximising benefits to clients.

Every real estate professional knows the importance of timing the market. For tenants, timing the market means signing leases when market conditions favour them. Because lease monetisations depend so heavily on long-term leases, market conditions influence the timing for these types of deals. Depending on the type of asset, there are better and worse times to pursue lease monetisations.

Consider the industrial market. Due to population growth and shifts in the way consumers shop, demand for industrial space is far outpacing supply. Investors and developers cannot build industrial product fast enough. Occupiers leased an unprecedented amount of industrial space in 2021.[5] Rents for modern warehouse product are surging, a trend acutely felt in the most desirable logistics locations across the country[6] (see Figure 10).

Net absorption exceeded expectations by a landslide, with 2021 absorbing over 496.3m sq. ft in the market.[7] For the first time in history, vacancy dropped below the 4 per cent threshold, with 2021 reporting a vacancy rate of 3.8 per cent.[8]

Since 2019 and the onset of the pandemic, industrial leasing has increased by more than 24 per cent.[9] Scarce availability in the market continued to push vacancy down in 2021. Strong leasing from prior quarters, and tenants making waves in occupancy throughout 2021, contributed to net absorption increasing by more than 81 per cent year-over-year.[10] Rents also continue to trend upward as the market grows even more competitive, with average asking rents at US$7.11 per sq. ft, year-over-year rents are up 11.3 per cent.[11]

Developers completed nearly 89m sq. ft of new industrial product in Q4 and 304m sq. ft across 2021.[12] Occupiers are preleasing with greater urgency than ever before (see Figure 11), eager to claim space and lock in rents before the market grows even more competitive. Nearly two-thirds of the product delivered in 2021 was preleased, up from 45 per cent in 2020 and 50 per cent in 2019.[13] The pipeline ended 2021 with 467m sq. ft under construction, which marks a 70 per cent increase from year-end 2020.[14]

Supply, especially modern product, is limited in prime submarkets (see Figure 12), contributing to outsized rent growth for

Total United States

Type	Total stock (s.f.)	Total vacancy	Total availability	YTD net absorption	YTD const. deliveries	Under construction	Q4 2021 avg. rent
Warehouse & distribution	10,545,089,059	4.2%	7.5%	473,804,331	298,346,265	446,297,053	$7.13
Manufacturing	3,504,186,501	2.7%	3.8%	22,454,392	6,580,381	20,478,680	$6.89
Special purpose	36,967,277	2.1%	3.0%	17,764	0	250,000	$9.54
Totals	**14,086,242,837**	**3.8%**	**6.6%**	**496,276,487**	**304,926,646**	**467,025,733**	**$7.11**

Figure 10 Demand for industrial space
Source: JLL Research

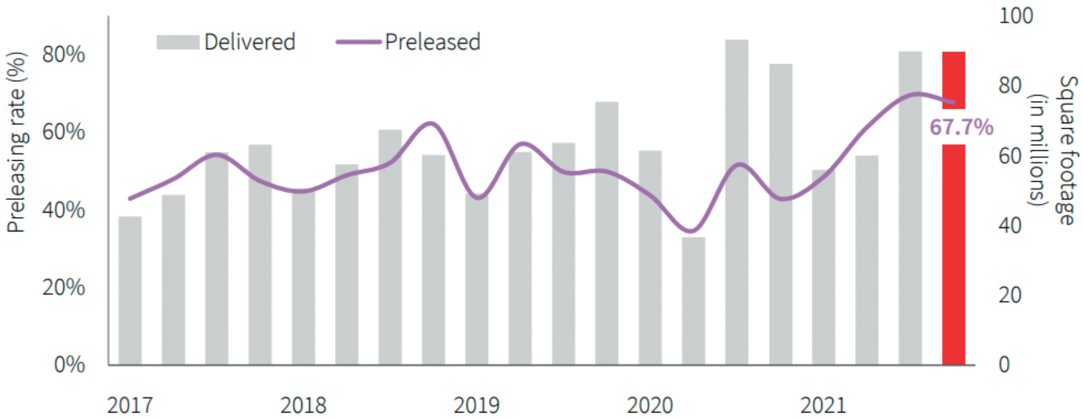

Figure 11 A shift in urgency to claim space before the market grows even more competitive has pushed preleasing rates to new highs
Source: JLL Research

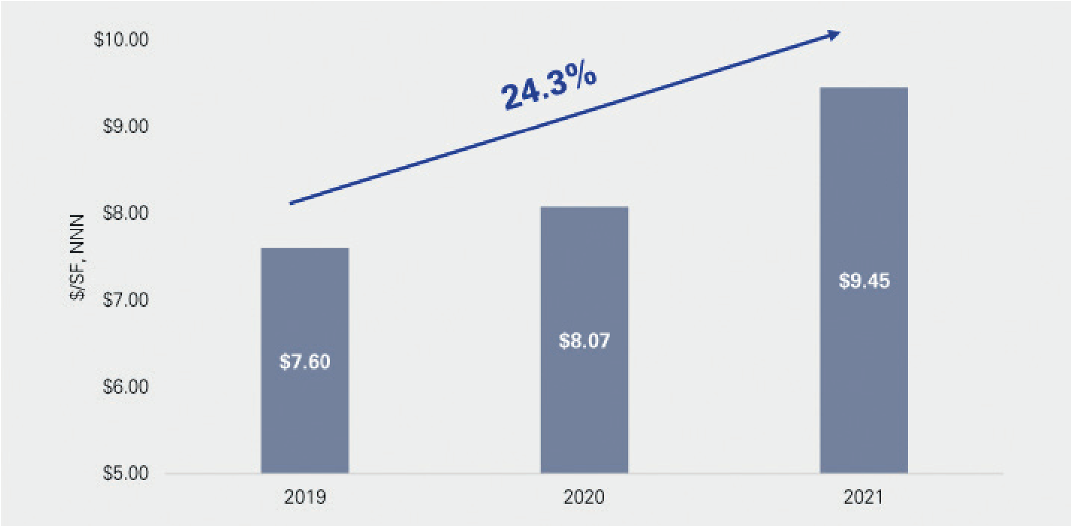

Figure 12 Taking rents in US prime submarkets surge — average first year rents for new construction in prime submarkets 2019–21
Source: Newmark Research, September 2021. *Average taking rent for buildings completed within past five years and greater than 100,000 SF.

new construction.[15] A prime submarket is often centrally located within a metropolitan area and offers access to critical infrastructure including airports, seaports, and major roads and rail lines — fundamental attributes for tenants focused on reducing transport costs and transit time.

In at least six of the US's prime industrial submarkets, average rents for new construction are poised to cross the US$10/sq. ft mark — or have already crossed it[16] (see Figure 13).

Industrial tenants that want to renew their leases have no leverage today because landlords know if a tenant leaves, they can replace them almost instantaneously. Likewise, most industrial owners want to hang onto their properties because of the unprecedented demand and growth. That means opportunities for lease monetisation for industrial space are few and far between unless a corporate user is pursuing a build-to-suit strategy or a sale-leaseback.

In contrast, the US office and flex markets are more than a little wobbly. Indeed, the pandemic has disproportionately affected office occupancy and created more instability across the US office market than any prior downturn in the real estate market. With new virus variants delaying return-to-office mandates, most companies have embraced a hybrid work model and are allowing employees to work remotely at least some of the time for the foreseeable future. Moreover, the success of remote working has compelled many companies to adopt some version of the policy in a more permanent way.

Many office users have made their space available for sublease (see Figure 14) and even more have postponed renewing their leases. Sublease space barely budged in Q4 2021 after dipping slightly during Q3 as re-entry remained subdued and tenants continue to assess their real estate strategies in light of further extensions of return-to-office timeframes.[17]

Despite the virus variants disrupting daily life and return-to-office policies still evolving, leasing velocity increased by 9.2 per cent in Q4 2021 (see Figure 15), pushing full-year leasing volume 14.6 per cent above

	Market	Prime Submarket	2021 New Construction Taking Rent ($/SF, NNN)*	Taking Rent Growth 2019 - 2021
1	Inland Empire, CA	West	$10.20	51.6%
2	Northern New Jersey	Meadowlands	$18.50	44.4%
3	Atlanta, GA	Northeast/I-85 Corridor	$5.25	40.0%
4	Dallas, TX	DFW Airport	$6.50	36.8%
5	Los Angeles, CA	South Bay	$16.20	28.1%
6	PA I-78/I-81 Corridor	Lehigh Valley	$7.00	26.4%
7	Phoenix, AZ	Glendale/Southwest Phoenix	$6.60	23.1%
8	Detroit, MI	Southern Wayne, City of Detroit	$7.25	21.8%
9	Salt Lake City, UT	Northwest Quadrant (NWQ)	$6.60	17.0%
10	Puget Sound	Seattle	$16.44	12.8%
11	Cleveland, OH	Southeast	$7.00	10.9%
12	Kansas City, MO	South Johnson County	$4.95	8.8%
13	Chicago, IL	O'Hare	$9.25	8.3%
14	Boston, MA	West/South	$8.30	8.1%
15	Miami, FL	Airport West	$9.13	7.4%

Figure 13 Notables US prime industrial submarkets: rent metrics — ranked by taking rent growth
Source: Newmark Research, September 2021. *Average taking rent for buildings completed within past five years and greater than 100,000SF.

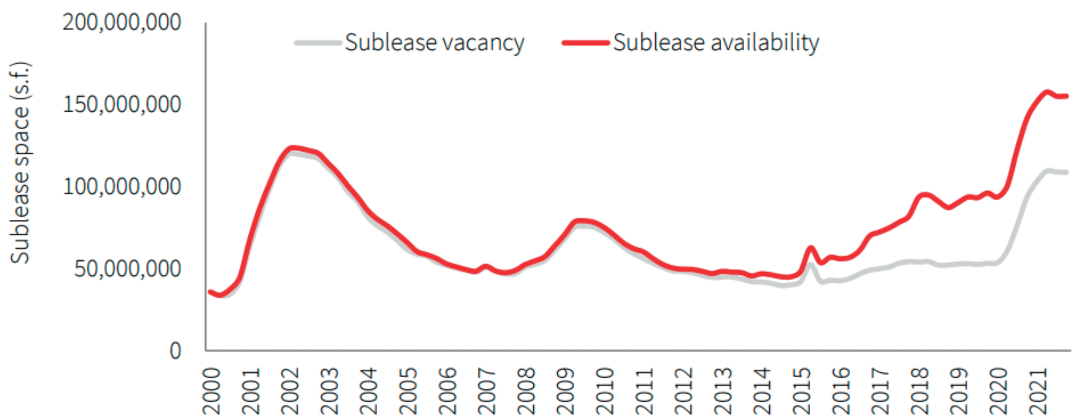

Figure 14 Sublease space (sq. ft)
Source: JLL Research

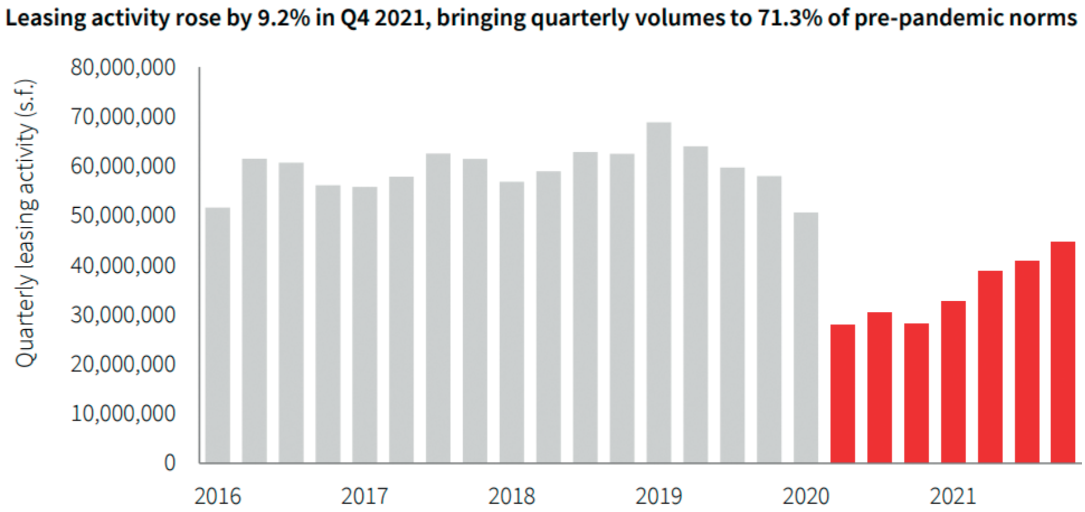

Figure 15 Leasing activity rose by 9.2 per cent in Q4 2021, bringing quarterly volumes to 71.3 per cent of pre-pandemic norms
Source: JLL Research

2020 levels, while sublease space stabilised and vacancy plateaued.[18]

With 5.4m sq. ft of net occupancy growth, absorption in Q4 2021 was positive for the first time since the onset of the pandemic.[19] Leading this were secondary growth markets, which saw a combined 2.6m sq. ft of expansion, with Seattle, Boston and New York also rebounding and the remaining gateway markets reporting slower negative net absorption (see Figure 16) than in previous quarters.[20]

Because of pandemic-related uncertainty, companies are not sure how much space they will need in the future or how they will use that space. They must ask themselves if, when and how they will return to their physical offices. The emergence of new variants makes those decisions more difficult. As a result, the entire office market — from skyscrapers in central business districts to multi-building suburban campuses — is facing an uncertain future. This uncertainty exacerbates the arbitrage opportunities discussed above, creating an ideal situation for corporate users who have a long-term growth strategy to pursue a lease monetisation strategy in their mission-critical leased assets.

In order to utilise the tools necessary for an optimal lease monetisation strategy, it is critical that corporate occupiers gain a better understanding of real estate capital markets. They must have a deep knowledge of the real estate markets in which they are located. If and when tenants discover that a property they occupy is for sale, they should leverage the investment sales process to their advantage. It is during this period that users can extract the most value from their future landlord.

Moreover, corporate users should take advantage of the tenant interviews that potential buyers typically conduct when under contract to acquire an asset. Occupiers should reach out to the potential buyer after the tenant interview, not only to learn about the entity, but also to float the idea of a lease monetisation. This is the one time when users will have maximum leverage in negotiations with their future landlord.

Additionally, tenants should always negotiate an information/notification section in their leases that requires notification when

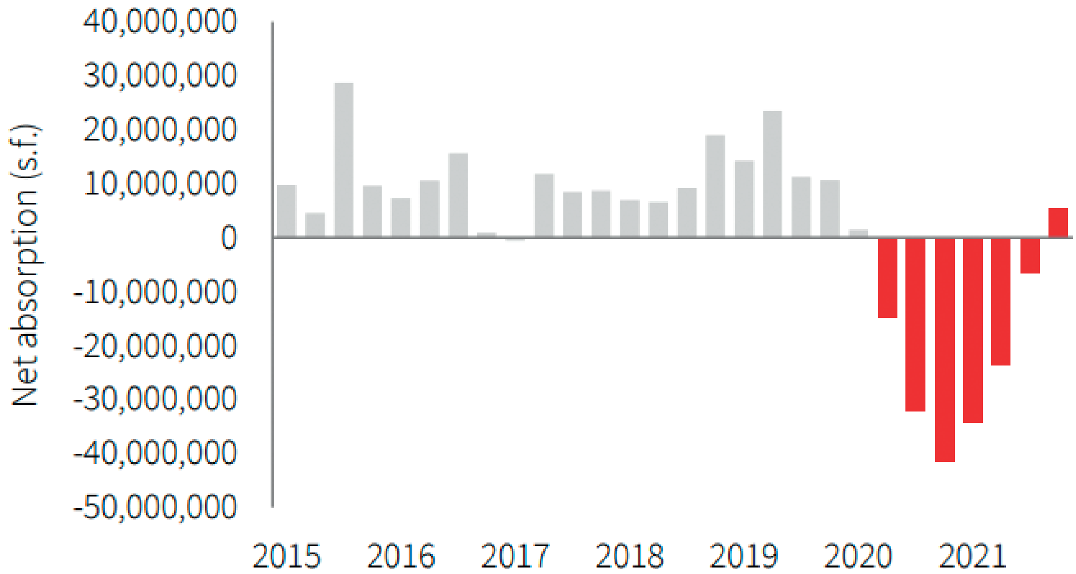

Figure 16 Net absorption (sq.ft)
Source: JLL Research

the building they occupy is for sale. This will allow corporate users to explore a lease monetisation strategy. All too often, a corporate user will try to sell its current landlord on a lease monetisation strategy instead of dealing with the potential buyer. When a landlord knows a tenant is willing to extend its lease, that tenant loses all leverage it would have had with the new landlord. If the existing owner/landlord believes its tenants are likely to stay and renew, the owner is likely to be less interested in selling.

THE NECESSITY OF FREQUENT EVALUATIONS

In conclusion, modern lease monetisations are an innovative way to create value for corporate users. This strategy has been successfully utilised by some of the most sophisticated Fortune 1000 companies. Corporate users should evaluate their current portfolio for lease monetisation opportunities and consider the strategy when looking to further reduce their occupancy costs on mission-critical facilities.

In order to capitalise on these opportunities, CRE executives must be closely aligned with the C-suite and their long-term business objectives. Understanding overall businesses objectives is crucial to implementing a successful real estate master strategy that can include lease monetisation. If a real estate team does not already speak regularly with the C-suite, lease monetisation is a high-value strategy that can be utilised to integrate real estate into those conversations. By leveraging the company's existing portfolio, occupiers can turn real estate into a value-added department rather than a sunk cost.

With an organisation's business objectives in mind, corporate real estate departments should regularly evaluate (at least semi-annually) their portfolio to identify lease monetisation opportunities and other 'low-hanging fruit'. Real estate executives should evaluate the portfolio in its entirety rather than considering individual transactions so any interdependencies or synergies can be identified.

Five items to focus on during evaluations:

(1) *Critical dates*: Lease end dates within eight years or less and renewal option notice periods;
(2) *Property importance*: Is the property and location mission-critical? As a corporate user's business progresses/changes, so may the importance of a particular location;
(3) *Number of renewal options remaining*: How many renewal options remain? Is the tenant already carrying those options on its books?;
(4) *Right of first offers (ROFO)*: Does the tenant have a ROFO to purchase the property? If so, this point can be leveraged or assigned to an investment partner for lease monetisation;
(5) *Mark-to-market analysis*: Tenants should check if rent is in line with the broader market, if the building is listed for sale, and if the debt matures in the next five years. These points can help tenants negotiate leases, as well as lease monetisation opportunities, but only if they are regularly evaluating the portfolio.

References

(1) CBRE (2021), 'The future of the office', available at https://www.cbre.com/insights/articles/the-future-of-the-office (accessed 28th March, 2022).
(2) *Ibid*
(3) Farina, S. and Godoi, R. (2021), Personal email correspondence.
(4) *Ibid*.
(5) JLL (2022), 'U.S. industrial outlook Q4 2021', available at https://www.us.jll.com/content/dam/jll-com/documents/pdf/research/americas/us/jll-us-industrial-outlook-q4-2021.pdf (accessed 28th March, 2022).
(6) *Ibid*.
(7) *Ibid*.
(8) *Ibid*.
(9) *Ibid*.
(10) *Ibid*.
(11) *Ibid*.
(12) *Ibid*.
(13) *Ibid*.
(14) *Ibid*.
(15) Newmark (2021), 'Double digits: The new rent metrics for prime warehouse space', available at https://www.nmrk.com/insights/thought-leadership/double-digits-the-new-rent-metrics-for-prime-warehouse-space (accessed 28th March, 2022).
(16) *Ibid*.
(17) JLL (2022), 'U.S. office outlook Q4 2021', available at https://www.us.jll.com/content/dam/jll-com/documents/pdf/research/americas/us/jll-q4-2021-us-office-outlook.pdf (accessed 28th March, 2022).
(18) *Ibid*.
(19) *Ibid*.
(20) *Ibid*.