Competitiveness of Lease Transactions

Process and Theory

In response to the Mayor Bowser's initiative to develop emergency family housing facilities across the District, the District of Columbia's (the "District") Department of General Services ("DGS") asked for Savills Studley's opinion as to how to determine whether lease costs are competitive with the market. The narrative below describes the theory behind the determination of a fair market lease transaction.

Background

As part of the District's plan to end homelessness, the District will close DC General, a former hospital that has served as the District's largest family shelter for seven years. The District will replace DC General by developing several emergency family housing facilities across the District. The District issued a solicitation to all developers and property owners ("Landlords") with development sites or existing buildings able to accommodate the District's initiative.

Determining the Economics of a Lease Transaction

The economics of any lease transaction (ie rent) are a function of a variety of factors. For a lease in a new development or substantially renovated existing building (like those sites selected by the District), the tenant's rent is largely a function of 1) market rent for other similar properties (as-is), 2) the costs to develop or redevelop the property, 3) the underlying land value and 4) the Landlord's expected return on investment based on the perceived risks of the transaction. By way of example, if a building costs $8.0 million to (re)develop, land value is $2.0 million and the market return on investment is 7.5%, the triple net lease rate associated with that property is $750,000.

	Item	**Value**
A	Development Costs	$8.0 million
B	Land Value	$2.0 million
C	Total Costs	$10.0 million (A+B)
D	Landlord Return on Investment	7.50%
E	District's Rent (nnn)	$750,000 (C*D)

Factors that will impact the economics of the transaction include:

- Type & condition of site/building
- Location of site/building (proximity to public transportation & amenities)
- Availability and price of comparable space
- Tenant's credit
- Tenant's use (ie. emergency housing), program (space requirements) & operations

- Lease term
- Capital investment
- Delivery risk
- Operational risk
- Lease terms and conditions (unique non-market terms can add cost)

Determining if Lease Terms are Competitive

For a typical lease transaction, the Lease Comparable Approach is utilized to determine the Fair Market Value (“FMV”) of the lease terms. This approach suggests that the determination of FMV depends on whether the lease terms in question are valued at a level similar to lease terms for similar properties and uses (ie office, retail, residential, industrial, etc).

The Lease (or market) Comparable Approach is based on the principle of substitution (i.e., the lease terms at a given property (“Subject Lease”) are worth approximately the same as lease terms at another property offering similar benefits or utility). The key features or characteristics of each comparable property and transaction characteristics (noted above) are compared to the Subject Lease and any differences are noted. Differences may be negative (i.e., further from public transportation or shorter lease term) or positive (i.e., better location or longer lease term) for the lease terms. The Subject Lease should be in the range of the lease terms at the most comparable transactions.

The important factors to be compared not only relate the building and market but also to the property’s use, lease terms and credit of the tenant. With respect to use, office leases are compared to office leases, retail leases are compared to retail leases and the same is true across all uses. This makes unique uses such as emergency housing particularly difficult to find good market comparisons. The major terms of the lease are also important and must be taken into account. The length of lease term and the amount of capital invested by the owner are just as important as the rent per square foot and must be evaluated relative to market. If the landlord is delivering the premises turnkey and accepting delivery and operational risk, this must be accounted for in the market analysis.

Unique Characteristics of the District’s Emergency Housing Requirement

The District’s emergency housing initiative has unique characteristics that will:

1. Impact the costs of the project
2. Alter the Landlord’s perceived value and risk profile (return on investment)
3. Limit the applicability of the Lease Comparable Approach (i.e. not many emergency shelter projects for which to compare)

A few of the unique characteristics of the District’s housing initiative include:

- **Use:** The unique District use (emergency housing) limits the number of developers and property owners willing to participate in this initiative. Many of these market participants do not fully understand the unique requirements and nuances of such a use and therefore decline to respond to the District's solicitation. As a result, many potential participants are reluctant to invest capital and forgo the opportunity cost of another use. Emergency housing facilities are also particularly difficult to find good market comparisons.

- **Market:** Many of the selected sites are in noncommercial submarkets with a limited number of recent and comparable transactions, therefore, reliable market information is unavailable for the Lease Comparable Method.
- **Supply of Options:** Due to the lack of willing market participants the economic terms tend to be high due to the limited supply of options / competition in the market.
- **Secondary Use:** The District's program (space requirements) limits the secondary use of the buildings at the end of the lease term and increases the capital investment required of the Landlord to convert the buildings to another use (ie market rate or affordable housing). As a result, landlords are forced to fully amortize their investment over the term of the initial lease.
- **Capital Investment and Development Risk:** If the selected sites require a significant amount of capital to be funded by the Landlord to either redevelop an existing building or build a new building, then the Landlord's stake in the project and potential risk increases as the Landlord's capital investment increases. The higher the risk, the higher the required return on investment.
- **Delivery Risk:** If the Landlords at the selected sites are required to deliver by a date certain, then this delivery risk will be reflected in the return on investment / rents.
- **Operating & Maintenance Risk:** If the operational, maintenance and repair risk has been placed on the landlord in these transactions, then the rent is going to reflect that responsibility. **T**he unique nature of the emergency housing operations will put additional strain on the building operations and maintenance requirements, the Landlord's cost to run the facilities and the associated operational risk will increase.