Lenders' Leased Fee Risk

Submitted by Ann Scott, February 15, 2018

Mattress Firm announced the closure of 200 stores in late 2017. Substituting "local" lease terms into those properties will weaken those properties' cash flow and potentially leave lenders short on debt service coverage. Collateral value may also suffer, further increasing lender risk. As lenders assess their portfolio position for properties housing retail operations, consideration needs to be given to potential changes in collateral value.

Mattress Firm's apparent willingness to pay above market lease rates created value in the leased fee interest. That value does not translate to the underlying real estate.

This same issue was evident when Blockbuster Video paid above market rents for prime high traffic, high visibility locations. Much like the internet sales of today creating a decline in brick and mortar retail sales, technology changes brought about the demise of the video/dvd rental business operation model. This left real estate investors with properties that were financed based on leased fee values which were above the fee simple market values. Some lenders were forced to charge off portions of those loans.

Fee simple estate or interest is "absolute ownership unencumbered by any other interest or estate…" Leased fee interest or estate is "a freehold (ownership interest) where the possessory interest has been granted to another party by creation of a contractual landlord-tenant relationship (i.e., a lease)." (Dictionary of Real Estate Appraisal, 5th Edition).

A fee simple interest value may differ widely from a leased fee interest value as illustrated below.

A+ Retail

The following chart gives an example of a standalone retail store. In this example, local lease rates range from $14.00/Square Foot (SF) to $19.00/SF with expense terms typically Net Net Net (NNN). NNN normally indicates that taxes, insurance, and utilities are paid by the tenant. The retail space has a national tenant, A+ Retail, which pays above market rents.

	Tenant name	SF	Expense Structure	Lease $/SF	Annual Income	Market $/SF	Est. Market Income	EXCESS RENT
1	A+ Retail	3,000	NNN	$30.00	$90,000	$19.00	$57,000	$33,000

The store is located at the intersection of Main and First streets which has the highest traffic counts in the county, good visibility, and excellent ingress and egress with a stoplight. In the

income approach for the leased fee scenario, the appraiser used a 2% vacancy/collection plus combined other expenses (management fee, parking lot maintenance, landscaping, and fees associated with business operations), that totaled just under 14%. The fee simple value based on local lease terms had a 2% vacancy/collection and other expenses that were just under 17%.

The national capitalization rate range for A+ Retail is 4.75% to 5.5% based on sales within the past 12 months. The local market capitalization rate range based on sales within the past 24 months is 7.25% to 8.25%. The local real estate market has been stable the past 24 months.

A+ Retail scouted the area and wanted this location due to the benefits noted and offered the owners the $30/SF lease rate that well exceeded market rate by about 58%. Based on the A+ lease rate and the national information, the leased fee interest value was $1,405,000 using the highest national cap rate. The appraiser, again noting the subject's superior attributes including location and traffic counts, opted to take the local market cap rate down to 7.00%, for a $665,000 fee simple value.

The $33,000 lease differential between the national and local market lease rates is excess rent. The $730,000 difference in the two values is excess value based on the excess rent of the A+ Retail lease. The difference is not value in the real estate. The excess value is in the lease itself.

The $730,000 also represents potential lender risk depending on the Loan to Value (LTV) utilized. Typical investors are going to want to minimize cash investment and will point to the leased fee value as the collateral value.

	A+ Retail Lease		**Market Lease**	
Lease Income	$90,000		$57,000	
NOI	$77,400		$47,310	
		Nat'l cap		Market Cap
	$1,407,273	5.50%	$675,857	7.00%
SAY	$1,405,000		$675,000	
Excess Value	730,000			

If 80% LTV is the lender's policy on income producing properties, the loan amount will vary from $540,000 based on the fee simple value to $1,124,000 based on the leased fee value. The difference between the two potential loan amounts is $584,000. This is the risk. In the above scenario, the lender opted to finance 75% of the leased fee value for a loan amount of $1,053,750. Note that this loan amount represents 156% of the fee simple value.

A couple of years pass and Amazon notices the success of A+ Retail and begins to offer the same goods delivered to buyers' homes with no delivery fee. Within an additional 24 months, A+ Retail is forced to close 30% of its stores and re-negotiate lease terms on most of the remaining stores. The excess value of the collateral will be extinguished by lease cessation. If the lease is renegotiated, the excess value may diminish or no longer exist.

In this scenario, the lender for the local A+ Retail store is handed the keys and a new appraisal is ordered. The local real estate market has, fortunately, held steady and the appraised value based on the fee simple interest is $675,000. The loan balance is $830,000. This leaves the lender with a $155,000 write off.

With the national lease in place, the original "market value" was based on the leased fee value. In the A+ Retail scenario, 52% of the leased fee value is in the lease and not the real estate. As previously noted, the 52% represents the majority of the lender's collateral risk.

Lenders MUST consider this risk when lending against those interests and MUST recognize the difference between the value in the underlying real estate versus the value in the lease itself.

Of note, the Appraisal Institute held a property rights symposium in 2017 and released a paper for comment on December 21, 2017, to solicit discussion and input on the valuation of fee simple interest in real estate sold as leased and other value definitions. There is a perceived need for clarification and possibly re-definition of the various real estate interests. The purpose is to assist users of the appraisals in understanding the values that are attached to the real estate versus the lease or other encumbrances' upon the property.

Best Practices

The appraisal engagement letter for a property encumbered by lease(s) should request both fee simple and leased fee values. The letter may include language to specify to the appraiser that the leased fee value should compare the lease to both the national tenant (if applicable) and the local market lease terms. It may also specify that the fee simple value should be based solely on local sales. For properties that are owner occupied with a "lease" in place, fee simple is the appropriate appraised value to request in most of those situations.

The appraisal should explain any value differential, particularly if there is a significant discrepancy; say more than 15%, between leased fee and fee simple values. Understanding the differential is critical to risk mitigation.

When the appraisal is reviewed, the lease terms within the appraisal should be compared with those of the lease to confirm the appraiser used the correct lease information. The appraisal should be analyzed to ensure that the appraiser compared the lease terms for the subject to the local market and, if a national tenant is involved, to the national terms for that tenant. A brief discussion on the differential is warranted. The capitalization rates for a national tenant compared to local cap rates should also be explained.

Management may want to reconsider the standard LTV guidelines when a leased fee value exceeds a fee simple value by a wide margin. A lower LTV or even a split LTV (say 80% on the real estate combined with 50% on excess value) may make more sense. In the A+ Retail scenario, the loan amount would have been $905,000. Arguably, the risk may be moderated by other collateral, by guarantor liquidity, or other factors. The loan proposal or write-up should acknowledge the value differentials and detail any mitigating factors.

The Final Analysis

Lenders must know their market(s), understand local lease terms, recognize above market lease terms, ascertain risk exposure, and lend prudently based on this knowledge.

Mattress Firm isn't the first and won't be the last tenant willing to pay a premium for high profile, high traffic locations to better promote its product or service. Given the record breaking retail store closures in 2017, it's a good time to re-assess retail collateral positions within lending portfolios.

Professional Bank Services, Inc. offers commercial appraisal review, appraisal function review and loan review services to the financial services industry. We would be pleased to work with you to perform, assess or improve these important functions. For additional information on Appraisal Services contact:

Ann Scott, Certified General Appraiser (Kentucky, Indiana)
Senior Consultant, ProBank Austin
502.479.5292
ascott@probank.com