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The Commercial Classroom: Lease buy outs

June 14, 2012 - Connecticut

The tenant no longer wants the space. What is the possibility of buying out of the lease obligation? Why should the landlord even consider letting the tenant out of their lease?

First, let's look at a couple of examples of how this might work. A tenant is paying $5,500 a month rent and had 16 months to go on their lease; the remaining lease obligation is $88,000. If a landlord agreed to the buyout, they may consider discounting the obligation based on the present value of money. In this case, if a discount rate of 10% were applied, the present value of the obligation would be reduced to $82,066. (To do this calculation, you need a calculator that is programmed to do discounting.) Not a big difference to a tenant in trouble.

Another example, a tenant with a long time left on the lease. This tenant is paying rent of $70,000 a year. They signed a ten-year lease three years ago. Their business is failing and they want to get out of their lease obligation.

Just to keep it simple, with no escalations, the overall obligation to the landlord for the next seven years is $490,000 (7 years X $70,000 annual rent). If this landlord agreed to the buy out, and discounted the obligation using a discount rate of 8%, the present value of the obligation would be reduced to $364,446. This is a significant discount, but still a lot of money. In reality the negotiations for a buy out start this way and usually end up with 50% to 75% of the obligation being required for the buy out.

Several major questions remain, can the tenant afford to do this? Perhaps major corporations can, but I don't see our Main St. tenants being able to do so.

Why should the landlord discount the obligation? The real question is, how is the market today? Will the landlord be able to rent the space for the same rent, more rent or lower rent? When the market is good the lease buy out gives the landlord more than sufficient money to lease the space without cash flow interruption. The dilemma is when we are in a declining market and the new rent would be less rent than the current tenant is paying.

Are there any alternatives? Perhaps the landlord could renegotiate the tenant's lease with lower rent. But how bad is the tenant's business situation? This may only be a temporary solution. The landlord could make the tenant fulfill their obligation by sub-leasing and having to subsidize the rent. (Can the tenant even afford that?) But what if the landlord does not work out a release and the tenant goes bankrupt? Also many tenants today have signed personal guarantees for their leases.

The request for a lease buy out creates serious considerations all around.

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