

Commercial Property Cash-flow Masterclass

Rent Reviews on Commercial Leases

Welcome to your Masterclass series. This Masterclass we are focusing on Rent Reviews in your commercial and retail leases and how to apply this when you are self managing your property.

From your perspective as a landlord, rent reviews are an important part of a commercial lease, because by reviewing the rent at specified intervals in the lease, ensures that the rent you are charging, keeps up to date with current market rates.

RENT REVIEWS V'S RENTAL INCREASES

Rental Increases:

Rental increases are written into your lease. These usually occur each year at the end of the lease year for each individual tenant and is at a fixed rate. This may be at CPI (Consumer Price Index) or a fixed percentage ranging between 2% and 5% and commonly between 3% and 4%.

This example lease for an office in Melbourne, shows there are no market rent reviews - but it has fixed annual rental increases of 3%

Item 16
[2.1.1, 11, 18

Review date(s):

Term & Further Term

- (a) *Market review date(s):* Not applicable
- (b) *CPI review date(s):* Not applicable
- (c) *Fixed review date(s) and percentage or fixed amount increase(s):* On each annual anniversary of the Commencement Date during the current term and upon commencement of any further term or on the annual anniversary of the Commencement Date during any period of over holding the Rent increases by 3%

To Calculate a Rental Increase.

For these rental increases, you simply inform your tenant that the rent review is increasing as per their lease and providing the new rental payment that will be due. Giving your tenant at least 1 month's advance reminder, is good practice.

For example, the annual rent may be \$20,000 Net, with yearly 4% rental increases. Just before the close of the first year, you would send a reminder notice that the rent will be increasing by 4% and you would give them the new rental amount they would need to pay:

We can simply multiply the Net Rent by 1.04 - since 1 is the existing rent amount and 0.04 is the rental increase ($\rightarrow 4\% = 4 / 100 = 0.04$)

So $\$20,000 \times 1.04 = \$20,800$ would be the new rent the need to pay in year 2 of their lease.

Rent Reviews (Market Rent Reviews):

Rent reviews reflect the current market rent and occur at specified intervals during the lease period.

Occasionally in the lease there may be a fixed CPI increase at the exercising of an option on the lease, but mostly they are calculated at market rate.

Market rent reviews are designed to ensure the rent you are charging, remains consistent with the rental rates being paid locally in the current market.

Market rent reviews are commonly carried out every 3 to 5 years and/or at the exercise of an option to renew. That's because market rent reviews may involve an independent valuation, the costs of which can be high, making them too expensive to carry out annually.

In well performing markets, market rent reviews provide a better rate of return. However, in poorer markets, they may result in a decrease in rent.

In this Brisbane property, you will see in green, that there are fixed annual rental increases at CPI or 3% - whichever is greater.
 And the Market Rent Review is scheduled at the option, which would then run for 3 years.

DATE (dd/mm/yyyy):

DATE (dd/mm/yyyy):

6. OPTION OF RENEWAL (IF ANY):

Note: The term of the lease (including options) should not exceed three (3) years.

Period of further term: 3 years

Final date for exercise of option: _____
 DATE (dd/mm/yyyy):

7. RENT:

\$ 48,000 Net per: month year ← Select applicable box

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8. RENT REVIEW:

Refer to clause 3.3

Note: Failure to review on these dates does not waive the Lessor's right to review.

Review Date	Type of Review
Annually Review Method: CPI or 3% whichever is the greater Market Review at option	<input type="checkbox"/> Index review <input type="checkbox"/> Fixed increase - amount of increase: _____ %
	<input type="checkbox"/> Index review <input type="checkbox"/> Fixed increase - amount of increase: _____ %

Calculating Market Rent Reviews:

Market Rent Reviews are based on the rent paid by tenants in comparable properties in the surrounding area. You calculate this on a comparable price per square meter for similar properties, and similar use businesses.

Say you find a property that's \$53,500 for 130.0m² then the price per sqm is
 $\$53,500 / 130.0\text{m}^2 = \411.50 per sqm

Do this for several properties - then calculate the average of all of them to come up with your market rate.

This amount is influenced by the supply and demand of such similar properties.

Market rent reviews can be carried out by you (the lessor), a property valuer or an estate agent.

The process for calculating market rent reviews, would be to find the comparable price per square meter (price per sqm) for the similar properties and then multiply that price per sqm by your own square meters of space - that you are renting to the tenant (net lettable area).

So if your research says that similar offices in the local area ,are renting out at \$150 per sqm and your office property is 88 square meters...

...Then you multiply the $\$150 \times 88 = \$13,200$ net rent annually.

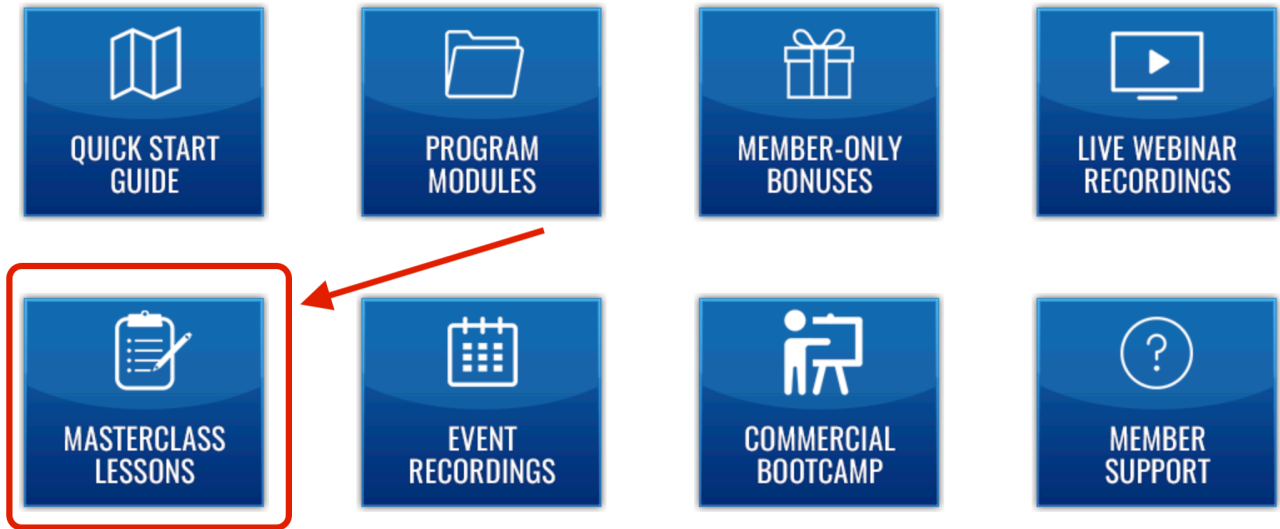
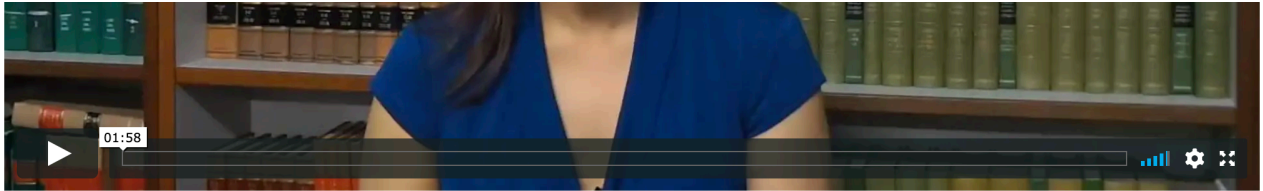
Additional Information & Resources

1. Previous Masterclass - “Managing Your Property” Detailed Information

MASTERCLASS SELF MANAGING YOUR PROPERTY

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Property Management
What To Do After Your Property Has
Settled.



2. R.P. Emery & Associates

Market rent review process:

The review process generally begins when you the landlord, sends a written notice to the tenant, proposing the new rental amount, based on your research and calculations. If the tenant agrees to that amount, your proposal is deemed to be the current market rent.

If the tenant disputes the new rental amount, landlord and tenant work together to agree on a fair market rent.

However, in the event an agreement can't be reached, and to ensure the review process is fair to both parties, most commercial leases include a clause allowing the tenant to have a valuer appointed to independently determine the market rent.

PLEASE NOTE: If your lease is a retail lease, the retail leasing legislation in your State imposes strict rules on how the market rent review process is to be carried out.

Time limits

To ensure market rent reviews don't drag on unnecessarily, it's wise to include a clause limiting the time the tenant has to dispute the reviewed rent.

Most commercial leases with provisions for market rent review state the new rent is deemed to be accepted if the tenant does not challenge the amount within a prescribed period – usually within 28 days of receiving the notice of review.

Independent reviews

If an independent review is required, both landlord and tenant have the opportunity to make written submissions to the valuer. A valuer's decisions are generally binding, and the costs of appointing them are shared equally between landlord and tenant.

Valuers have a wide discretion when applying valuation principles to a market review. That's why it's important to ensure rent review clauses contain valuation criteria for the review. These criteria set out the directions the valuer must follow, assumptions they should make, matters they must take into account, and matters they should disregard.

Initiating a market rent review

Who can initiate a market rent review depends on the terms of your lease. However, most commercial leases allow either party to initiate a review. That said, there are some important differences you should note between retail and commercial leases.

Under section 32 of the New South Wales *Retail Leases Act*, the tenant has the right to request a rental determination. If that determination is not made before the option date occurs, the option period is extended until the tenant is notified of the determination. This is so that the tenant may take into account the new rental amount when determining whether or not to take up the option to renew the lease. In addition, where an early determination is made, the tenant must exercise their option within 21 days of the determination – *not the timeframe noted in the lease*.

(Note that the requirements concerning the procedure for “retail” market rent reviews will vary slightly from state to state.)

Time is also an important factor in a commercial lease. As a landlord, you should ensure you prescribe a time limit in which you have the right to initiate the review process. Take careful note of these limits, because if you fail to act within that time, your tenant may claim you have lost the right of review. This is particularly so if the lease states that time is of the essence.

Ratchet clauses

Because market rent reviews are based on current market rates, they may result in a decrease in rent. Landlords have been known to guard against this by including a ‘Ratchet clause’ in the lease, prohibiting a decrease of rent after a market rent review.

Once common in commercial leases, it’s important to note that Ratchet clauses are void and unlawful in *retail leases* under state and territory legislation. Under a retail lease, the market rent review is a ‘true market rent review’, meaning the new rent may be less than the rent prior to review.

<https://www.findlaw.com.au/articles/5646/rent-reviews-and-commercial-leases.aspx>